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COMMITTEE PRINT

RECONCILIATION SUBMISSIONS OF THE INSTRUCTED COMMITTEES PURSUANT TO THE CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1988 (H. CON. RES. 93, REPT. NO. 100-76)

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

OCTOBER 1987

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WASHINGTON, DC 20510-6000

October 19, 1987

Honorable Lawton Chiles
Chairman
Committee on the Budget
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This letter and the attachments constitute the submission of the Committee on Agriculture, Nutrition, and Forestry to meet its reconciliation instruction under H. Con. Res. 93. The Committee met on October 19 and unanimously approved its submission. Our recommended changes are highlighted in the attachments.

In a very real sense, American agriculture started to make its contribution to deficit reduction a year ago when the 1985 Food Security Act was implemented. The 1985 farm bill has already saved $3 billion this year and will save $9 billion over the three year period covered by the budget resolution. Our reconciliation submission meets the Agriculture Committee's instruction as set forth H. Con. Res. 93, helps to reduce this year's deficit, prevents future farm program spending from accelerating, and maintains the basic principles of the 1985 Food Security Act.

We look forward to working with you to insure the adoption of the Committee's legislative proposals as part of the reconciliation bill.

Sincerely,

Richard G. Lugar
RICHARD LUGAR
Ranking Minority Member

PATRICK LEAHY
Chairman

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

SUMMARY OF THE COMMITTEE'S RECOMMENDATIONS

The Committee's budget reconciliation recommendations address changes in seven main farm program areas: acreage reduction programs, Rural Electric Administration lending, dairy policy, food labeling, deficiency payments, the use of proven yields in farm program operations, and farmer held storage payments.

In brief, the Committee's proposals include a "Triggered Acreage Reduction Program" for wheat and feed grains. If stocks of wheat or feed grains are projected to exceed certain trigger levels, the Secretary would be required to increase the amount of land a producer must idle, in order to participate in the price support programs for wheat or feed grains.

The Committee is recommending that the Secretary of Agriculture be limited with respect to the degree regional, state, or county loan rates may be adjusted to reflect transportation and other differentials. The Secretary adjusted these differentials for the 1987 crops. This adjustment has had a substantially negative impact on farmers in certain states. The average 1987 loan rate for wheat in Montana, for example, is more than 8% below 1986 levels.

The Committee's proposal would amend the acreage reduction provisions for oats and barley. The United States is currently importing oats, and oat stocks are dropping to the 100 million bushel mark, while barley stocks remain high. This proposal would allow the Secretary to provide for a different acreage reduction requirement for oats than is in place for barley. This amendment will lower barley stocks, lower oat imports, and generate savings.

The dairy proposal modifies the Agricultural Act of 1949 by exploiting the success of promotion of milk and milk products and by easing the impact of potential price support reductions. A five cent increase in 1988 promotion assessments, divided between local and national efforts, will boost consumer demand and hold down government purchases. The structure of the current dairy price support program will be maintained with price cuts triggered when it is estimated that purchases of milk by the Commodity Credit Corporation will exceed 5 billion pounds. For 1988, there will be two trigger dates--January 1 (with a potential 20 cent per hundredweight cut) and July 1 (with a potential 25 cent per hundredweight cut). Subsequent to 1988, the trigger dates will fall on July 1.

With respect to the 1988 through 1990 crops, the Secretary will be directed to pay at least 40% of wheat and feed grains and 30% of rice and cotton deficiency payments in advance.

For the 1987 through 1990 crops of wheat, 90% of the final deficiency payment (the so-called Findley payment) will be moved up to coincide with the regular deficiency payment. The final 10% will be paid at the end of the year, and will be used to adjust for any differences in the Secretary's estimated payment and the payment finally determined to be due producers.

The package will also reimburse producers for adjustments in payment yields made by the Secretary. This protection will extend through the 1990 crop year. Producers will be compensated if the calculation of farm program payment yields provided for in the Food Security Act of 1985 causes such producers' yields to fall more than 5 percent below the producer's 1985 farm program payment yield.

The Committee's proposal adjusts the annual storage payment rate on farmer held reserve storage from twenty-six and one-half cents per bushel per year to twenty-eight and one-half cents per bushel per year for the 1988 through 1990 crops.

The Committee is proposing that Rural Electrification Administration ("REA") borrowers be allowed to prepay Federal Financing Bank loan advances. A processing fee must be paid on each prepayment. The fee on each prepayment would be 50 basis points plus 50% of the difference between the interest rate on the loan advance and the cost of money to the government.

The Committee also proposes to allow REA borrowers to voluntarily establish cushion-of-credit accounts within the Rural Electrification and Telephone Revolving Fund. Amounts in the Fund would earn interest at the average rate on certificates of beneficial ownership issued by the Fund. Borrowers would receive interest at a rate of 5% on their advance payments. Income from this interest differential would finance borrowers' rural development projects.

The Committee is also recommending other revisions to current law including a provision that would allow REA borrowers to invest up to 15% of their total utility plant in non-Act purposes and a provision that would allow Rural Telephone Bank ("RTB") borrowers to prepay RTB loans without penalty and would require RTB to apply its current cost of money rate to future loans at the time of advance.

The Committee is recommending several miscellaneous changes in existing law as a part of the reconciliation proposal. These changes include the labeling of products containing meat and imitation cheese and a provision setting forth the sense of the Congress concerning the use of ethanol as a motor fuel.

BACKGROUND

H. Con. Res. 93 provided budget reconciliation instructions to the Committee on Agriculture, Nutrition, and Forestry, which required savings totaling $1.33 billion from the level of spending expected as of January 1987 in the 1988 fiscal year on programs under the jurisdiction of the Committee. Reductions in the amount of spending expected for the fiscal years 1988 through 1990 must total $5.838 billion. In addition, the Committee was instructed to raise revenues of $7.2 billion through the prepayment of Rural Electrification Administration Loans. The Committee met and surpassed those targets.

The long-term nature of the agricultural economy makes these reductions in spending particularly difficult to achieve. It takes a year to plan and raise a crop, and can take more than a year to market it. It takes several years to change the direction of the livestock industry.

Each drop in spending impacts directly on the well-being of all U.S. farmers in difficult economic times. Within this context, the Committee has attempted to make the required savings without reducing the income of hard-pressed farmers throughout America.

This task has been made easier by a number of factors, primarily the fact that the cost of agricultural programs has begun to come down from 1986 levels. There is every indication that program costs will continue to decline. Since the spring of 1987, when the Budget Resolution was first considered in Congress, the agricultural situation in the country has improved. Farm exports are up. Stocks have declined. Land values have stabilized. Prices for many major commodities are rising. American agriculture has turned the corner.

As a result, recent estimates of spending for farm programs in fiscal year 1988 are over $3 billion dollars less than that projected in January 1987. Spending levels are expected to decline from the January estimates by at least $9 billion over the three year period covered by this budget resolution.

The recommendations of the Committee will reduce by over $6 billion the amount of agriculturally related spending expected, as of January 1987, in the fiscal years 1988 through 1990. Agriculture is making its contribution to deficit reduction.

SECTION-BY-SECTION ANALYSIS

SUBTITLE A--AGRICULTURAL PRICE SUPPORT PROGRAMS

SEC.1011. FEED GRAIN ACREAGE REDUCTION REQUIREMENTS FOR OAT PRODUCERS.

This section authorizes the Secretary of Agriculture to establish different acreage reduction requirements for producers of oats than exist for producers of other feed grains, including barley. This provision will lower barley stocks, lower oat imports, and generate budget savings.

This section provides that the Secretary of Agriculture may provide for a smaller acreage reduction requirement for oat producers in order to encourage the planting of oats. Under this recommendation, any such oat acreage reduction requirement could not call for a producer to make more than a 20 percent reduction in the amount of planted base acres for oats.

The Secretary has interpreted the 1985 farm bill as requiring the same acreage reduction for both the oat and barley programs. The base acreage for barley and oats are combined into a common base. While the variable production costs and yields for the two crops are similar, the target price for barley is approximately one dollar per bushel higher than oats. Because of the target price differential, the returns from planting barley are $25-$30 per acre higher than from planting oats.

Harvested oat acreage has declined every year since 1980, falling from 10.3 million acres to 7 million acres in 1986. It is estimated to have increased only slightly to 7.3 million acres in 1987. The United States is now importing 30-35 million bushels of oats annually.

In contrast, harvested barley acreage has increased since 1980, reaching 13.2 million acres in 1985. Harvested acreage fell in 1987 due to acreage reductions resulting from strong program participation by producers of barley. Over 120 million bushels of barley remain in the Farmer-Owned Reserve. Four million bushels of oats are held in the same category.

If the acreage reduction requirement for oats is lowered to 5 percent or less, the difference in returns between barley and oats falls to $10-$15/acre. This change should provide the barley/oat producer with some incentive to shift acres out of barley and into oats, which will lower barley stocks and oat imports.

SEC.1012. ADVANCE PAYMENTS.

Section 1012 amends section 107C of the Agricultural Act of 1949 (the "1949 Act") to provide that, for the 1988 through 1990 crops of wheat, feed grains, upland cotton, and rice, if the

Secretary of Agriculture determines that deficiency payments will likely be made for any of such commodities, the Secretary shall make deficiency payments available in advance to producers of these commodities. The Secretary may make up to 40 percent of the expected wheat and feed grains deficiency payments and up to 30 percent of the expected cotton and rice deficiency payments in advance.

Under section 107C(a) of the Food and Security Act of 1985, the Secretary can pay up to 50 percent for wheat and feed grains and 40 percent for rice and cotton of estimated deficiency payments in advance. No minimum level is specified. The Committee believes that the advance payments mandated by this amendment will help farmers reduce the costs of financing their crops at the beginning of the season. Mandating these advance payments for FY 1988-1990 will further provide some assistance in financial planning in future years.

SEC.1013. ADVANCED EMERGENCY COMPENSATION PAYMENTS FOR 1987 THROUGH 1990 CROPS OF WHEAT.

Section 1013 amends section 107D of the 1949 Act to require the Secretary of Agriculture to estimate by December 1 of each of the marketing years 1987 through 1990 the national average market price per bushel of wheat received by producers during each of such marketing years. The Secretary shall, by December 15 of each marketing year, make 90 percent of the estimated final wheat deficiency payment available to producers who have elected this payment option.

For the 1987 crop of wheat, producers may elect the payment option under this section no later than December 1, 1987. For the 1988 through 1990 crops of wheat, producers must elect this payment option at the time of signup. Under traditional tax rules, producers would be attributed income in the year in which the payment is received.

This amendment requires the Secretary to make 90 percent of the so-called Findley portion of the wheat deficiency payments available in December of the marketing years for the 1987-1990 crops to producers who have elected this payment option. Section 107(D)(c)(1)(E) of the Agricultural Act of 1949 currently provides that such payments will be made at the conclusion of the marketing year. The estimated payment provided for by this amendment would be based upon the Secretary's projection of the season average price for each year. The balance of such payments, if any, would be made at the end of the marketing year.

SEC.1014. ACREAGE LIMITATION PROGRAMS FOR 1988 THROUGH 1990 CROPS OF WHEAT AND FEED GRAINS.

Subsection (a) of this section revises the acreage reduction requirements for the 1988 crop of wheat to provide that if carryover stocks of wheat, as estimated on June 1 of the year previous to the year in which the crop is harvested are--

(1) more than 1,900,000,000 bushels, the Secretary of Agriculture shall establish an acreage limitation program under which the acreage reduction requirement would be a 35 percent reduction from the crop acreage base;

(2) more than 1,000,000,000 bushels but not more than 1,900,000,000 bushels, the Secretary of Agriculture shall establish an acreage limitation program under which the acreage reduction requirement would be at least a 20, but not more than a 30, percent reduction from the crop acreage base; and

(3) 1,000,000,000 bushels or less, the Secretary of Agriculture shall establish an acreage limitation program under which the acreage reduction requirement would be not more than a 20 percent reduction from the crop acreage base.

Subsection (b) revises the acreage reduction requirements for the 1988 through 1990 crops of feed grains as follows:

(1) if the Secretary of Agriculture estimates that carryover stocks of corn will be above 5,850,000,000 on the first day of the 1988 marketing year for corn, the Secretary shall provide for an acreage reduction requirement for the 1988 crop that is 7.5 percent higher than the percentage acreage reduction required for the immediately preceding crop year;

(2) if the Secretary of Agriculture estimates that carryover stocks of corn will be above 6,000,000,000 on the first day of each of the 1989 and 1990 marketing years for corn, the Secretary shall provide for an acreage reduction requirement for each of such crops that is 5 percent higher than the percentage acreage reduction required for the immediately preceding crop year, in the case of the 1989 crop, and is 3.5 percent higher than the percentage acreage reduction required for the immediately preceding crop year, in the case of the 1990 crop;

(3) if the Secretary of Agriculture estimates that carryover stocks of corn will be above 2,000,000,000 bushels but not more than 5,850,000,000 on the first day of the 1988 marketing year for corn, the Secretary shall provide for an acreage reduction requirement for the 1988 crop of at least 12.5 percent but not more than 20 percent;

(4) if the Secretary of Agriculture estimates that carryover stocks of corn will be above 2,000,000,000 bushels but not more than 6,000,000,000 on the first day of each of the 1989 and 1990 marketing years for corn, the Secretary shall provide for an acreage reduction requirement for such crops of at least 12.5 percent but not more than 20 percent; and

(5) if the Secretary of Agriculture estimates that carryover stocks of corn will be 2,000,000,000 bushels or less on the first day of each of the 1988 through 1990 marketing years for corn, the Secretary shall provide for an acreage reduction requirement for such crops of not more than 12.5 percent.

The Committee recognizes that excessive stocks of government owned surplus commodities represent a major obstacle to the recovery of prices of agricultural commodities. The Committee further recognizes that when commodity stocks reach such levels, that firm, corrective action is needed to limit farmers incentives to produce even more.

In order to meet this major policy goal, and to generate budget savings, the Committee recommends that the Secretary be authorized to increase the land a producer must idle without receiving a direct payment in order to obtain program benefits.

In the case of feed grains, the Secretary will be given this authority, if beginning stocks of corn for the 1988 crop exceed 5,850,000,000 bushels. This stock trigger for raising the acreage reduction level will increase to 6,000,000,000 bushels for the 1989 and 1990 crop years.

Each year stocks exceed the trigger level, the Secretary will be allowed to set progressively larger acreage reduction levels. For feed grains, the Secretary would be allowed to raise the acreage reduction level to 36% in the 1990 crop, if trigger levels are met in each of the three years. This would amount to an 80% increase in the land a farmer would be required to take out of production, an action which would have a substantial impact on the producer.

The land required to be idled for wheat is increased by 5% for the 1988 crop, if 1988 beginning wheat stocks are projected to exceed 1,900,000,000 bushels.

The Committee recommends that these steps be taken, if needed, to preclude both an increase in stocks, and an increase in the cost of the program.

Program costs are projected to fall in the future. Moving from $24.4 billion in Fiscal Year 1988, costs are projected to decline to $20.3 billion, without any reconciliation action. The recommendation regarding acreage reduction program levels and stock triggers should help ensure that agriculture remains on that path.

SEC.1015. PRODUCER RESERVE PROGRAM FOR WHEAT AND FEED GRAINS.

This section amends section 110 of the 1949 Act to provide that producer reserve storage payments made to producers for each of the 1988 through 1990 crop years shall not be less than $0.285 per bushel of wheat or feed grains stored by the producers.

This is an increase in storage payments of $0.02 per bushel which will restore some equity to the difference between storage payments for the farmer owned reserve and commercial storage. The committee believes this increase is crucial to farmers who have not benefited from a rate increase since January 1980. Meanwhile, commercial rates have been adjusted nearly every year. The average commercial rate for 1987-88 warehouse storage is 34.5 cents per bushel.

SEC.1016. DAIRY PRICE SUPPORT PROGRAM.

Subsection (a) of this section amends section 201(d) of the 1949 Act to provide as follows:

(1) if the Secretary of Agriculture estimates on January 1, 1988, that the level of purchases of milk and milk products under section 201(d) will exceed 5,000,000,000 pounds during 1988, the Secretary shall, on January 1, 1988, reduce by 20 cents the rate of price support for milk as in effect on such date;

(2) if the Secretary of Agriculture estimates on July 1, 1988, that the seasonally adjusted level of purchases of milk and milk products under section 201(d) will exceed 5,000,000,000 pounds during 1988, the Secretary shall, on July 1, 1988, reduce by an additional 25 cents the rate of price support for milk as in effect on such date; and

(3) if for any of the calendar years 1989 and 1990, the Secretary of Agriculture estimates on July 1 of such calendar year that the seasonally adjusted level of purchases of milk and milk products under section 201(d) will exceed 5,000,000,000 pounds during such calendar year, the Secretary shall, on July 1 of such calendar year reduce by 50 cents the rate of price support for milk as in effect on such date.

Subsection (b) of this section amends section 115(g) of the Dairy Production Stabilization Act of 1983 to provide for an additional assessment of $0.05 per hundredweight of milk purchased for commercial use from producers during the calendar year 1988. This assessment is for promotion purposes and will be evenly divided between regional and national dairy product promotion programs.

The Committee notes the success of the dairy program over the past two years. The cost to the American taxpayer has been cut by more than half, surplus stocks have been slashed, and for most of the country, production has stabilized. Consumer demand for dairy products has grown as dairy farmers have assessed themselves to pay for increased advertising.

In order to keep this demand momentum growing, the Committee recommends an additional 5 cent assessment to be paid by each dairy farmer for product promotion throughout 1988. These funds, split between local and national efforts, will give the "demand side" a boost and will result in less surplus purchase by the Commodity Credit Corporation.

In addition to supporting increased demand, current dairy policy reflects the need to control supply. The Dairy Termination Program accomplished the task of bringing down supply. With the completion of this program, the 1949 Act requires the Secretary of Agriculture to make a projection, a year in advance, of CCC purchases, beginning January 1, 1988. If CCC purchases are above 5 billion pounds of product, then a price cut is triggered.

The Committee recommends that the 1988 cut be phased in, with a 20 cent cut per hundredweight on January 1, 1988, if CCC purchases are projected, by the Secretary of Agriculture, to be above 5 billion pounds. A second cut of 25 cents per hundredweight would be triggered on July 1, based on a second evaluation by the Secretary, if CCC purchases again exceeded the 5 billion pound trigger. Thereafter, the trigger dates would be set on July 1 of each succeeding year.

The Committee recommends these changes in the dairy program (1) to give the Secretary of Agriculture a more firm basis for making year long projections of CCC purchases, and (2) to time the potential price cuts at the mid point of the dairy year, after spring flush. In regard to the first consideration, the Committee recommends that the Secretary's July projections be seasonally adjusted, taking into account the variation in year long CCC purchase and selling patterns.

The Committee is concerned about recent reports of increased dairy production in specific areas of the country and will follow future production reports carefully as it reviews the performance of the dairy industry.

SEC.1017. LIMITATION ON LOAN RATE ADJUSTMENTS FOR TRANSPORTATION DIFFERENTIALS.

This section amends section 403 of the 1949 Act to restrict the degree that state, region, or county loan rates may be adjusted to reflect transportation and other differentials. The section limits such adjustments to the percentage change in the national average loan rate plus or minus 1 percent.

Under current law, the Secretary may raise or lower an individual county loan rate to reflect differences in transportation costs and other factors. Earlier this year, the Secretary adjusted virtually all county differentials, voluntarily limiting any reduction to no more than five percent. In addition, the Food Security Act of 1985 mandated a five percent reduction in the national average loan rate.

In some counties the combination of the national loan rate decline and the differential adjustment reduced loan rates in excess of the five percent anticipated under the 1985 Act. For example, the decline in wheat loan rates in Oklahoma, North Dakota, and South Dakota was about eight percent. In other states the combination produced an overall reduction in loan rates of less than five percent; in Kansas, the wheat loan rate declined by less four percent.

Many producers have made plans for their farm operations based on loan rates anticipated under the 1985 Act. The Committee believes that unexpected discretionary reductions in loan rates should be avoided or at the very least minimized. The limit on the Secretary's discretion under this section is intended to accomplish this end.

SEC.1018. COMPENSATION FOR REDUCED FARM PROGRAM PAYMENT YIELDS.

This section amends section 506(b)(2) of the 1949 Act to provide that in the case of each of the 1988 through 1990 crops of wheat, feed grains, upland cotton and rice, if the farm program payment yield for a farm is reduced more than 5 percent below the farm program payment yield for the 1985 crop year, the Secretary shall make available to producers established price payments for the commodity. The payments shall be made in the form of commodity certificates. These payments shall be made in such amounts as the Secretary determines is necessary to provide the same total return to producers as if the farm program payment yield had not been reduced more than 5 percent below the farm program payment yield for the 1985 crop year.

Such payments shall be made available to producers at the time that the final deficiency payments under the wheat, feed grains, upland cotton, and rice programs are made available to producers.

Under current law, the Secretary may determine program payment yields by averaging the farm program payments yields for the years 1981-1985 or by calculating a five year rolling average of the yield per harvested acre for each crop a producer enrolls in a Federal farm program. The Secretary has chosen the former method for the 1986, 1987, and 1988 crops.

Producers were compensated for reductions in program payment yields beyond three percent in 1986, and five percent in 1987. The policy of providing farmers with reimbursement expires with the 1987 crop. The Committee believes that reductions of more than 5 percent in the farm program payment yields should continue to be compensated for as they were in the 1987 crop year.

SUBTITLE B--PREPAYMENT OF LOANS

SEC. 1021. PREPAYMENT OF LOANS

This section amends Section 306A of the Rural Electrification Act of 1936 to allow Rural Electrification Administration ("REA") borrowers to prepay loan advances to the Federal Financing Bank. A processing fee will be charged on each prepayment; the fee is calculated by adding 50 basis points plus points equal to 50 percent of the difference between the interest rate on the loan advance being prepaid and the cost of money to the government at the time of prepayment. Charges in addition to principal and processing fee are expressly prohibited.

The borrower may, at its option, amend the existing guarantee to include the amount of the principal balance prepaid, the amount of the processing fee, and the cost to the borrower of obtaining private capital. Borrowers who already had been determined by REA to be eligible to prepay in fiscal year 1987 may prepay under any combination of terms and conditions applicable to such prepayments under section 306A of the Rural Electrification Act of 1936 as in effect prior to this amendment.

SEC. 1022. USE OF FUNDS

This section amends Title III of the Rural Electrification Act of 1936 by adding a new section which allows an REA borrower to invest its own funds or to make loans or guarantees not in excess of 15 percent of its total utility plant.

The Committee recommends the adoption of section 1022 in order to allow rural cooperatives to meet needs in their communities beyond providing electric service. Cooperatives are in a position to advance the development of distressed rural areas. They have demonstrated their capacity for development by facilitating water and waste disposal projects, as well as business development. Section 1022 would amend a current administrative restriction which limits a borrower's investment in non-Act purposes to 3% of total utility plant and replace it with a 15 percent limit.

SEC. 1023. CUSHION-OF-CREDIT PAYMENTS PROGRAM

This section amends Title III of the Rural Electrification Act of 1936 by adding a new section which allows REA electric and telephone borrowers to make voluntary advance payments to cushion-of-credit accounts within the Rural Electrification and Telephone Revolving Fund ("Fund"). A borrower may reduce the balance of its cushion-of-credit account only to make scheduled payments on loans made or guaranteed under the Act.

Amounts in these accounts will earn 5% interest for the REA borrower from REA; meanwhile, all cash balances held by the Fund will bear interest to the Fund at the average rate on certificates of beneficial ownership issued by the Fund. Income from this interest differential will flow into a special Rural Economic Development Subaccount within the Fund. The Administrator is authorized to make grants or zero interest loans to borrowers to promote rural economic development and job creation projects. Such loans and grants shall be made during each fiscal year to the full extent of the amounts held by the subaccount.

The Committee recommends that section 1023 be implemented to promote rural development for the reasons outlined in the discussion of section 1022 above. In addition, the Committee finds that this program renders REA's lending position more secure because a borrower's advance payment into the cushion-of-credit account may be used in the future in lieu of a loan payment to REA.

SEC. 1024. RURAL TELEPHONE BANK

This section amends section 408(b) of the Rural Electrification Act of 1936. It requires that the Rural Telephone Bank ("RTB") apply its most current cost of money rate at the time of each advance on future loans. This section also allows an RTB borrower to prepay a loan during fiscal year 1988 without paying prepayment penalties set forth in the note covering such loan. The Governor of RTB is directed to issue regulations to carry out this amendment; such regulations may not further restrict participation in these programs.

The Committee finds that existing statutory authority directs RTB to set its interest rates at its cost of borrowing and to carry out its operations in a self-sustaining manner. According to a financial audit by the General Accounting Office, RTB's interest rates have exceeded its cost of borrowing, resulting in accumulated earnings of some $60 million over the 1984-86 period. The Committee disapproves of this practice.

By applying the interest rate at the time of advance rather than at the time of commitment, RTB will in the future apply a rate much closer to its cost of borrowing. By allowing RTB borrowers to prepay without penalty, this section will provide some relief to borrowers who are burdened by past overcharges. It is the intention of the Committee that the Governor of RTB add no further restrictions to borrowers' prepayment and no further restrictions to application of interest rates at the time of advance.

SUBTITLE C--MISCELLANEOUS

SEC.1031. RURAL INDUSTRIALIZATION ASSISTANCE.

This section amends section 310B(c) of the Consolidated Farm and Rural Development Act by allowing private nonprofit corporations to participate with public bodies in a grant program to finance and facilitate development of small and emerging private business enterprises.

The Committee recommends that private nonprofit corporations be included as recipients in this grant program because nonprofit community development corporations across the country have demonstrated their ability to successfully foster economic development in distressed rural areas. By financing small and emerging businesses, this program can work more effectively to stimulate job growth in rural communities.

SEC.1032. PLANT VARIETY PROTECTION FEES.

This section amends section 31 of the Plant Variety Protection Act to provide that the Secretary of Agriculture shall charge and collect reasonable fees for the services performed under the Plant Variety Protection Act. The section authorizes the Secretary to charge a late payment penalty for overdue fee payments.

All fees, payment penalties, and collected interest shall be credited to the account that incurs the cost and shall remain available without fiscal year limitation to pay the expenses incurred by the Secretary in carrying out the Plant Variety Protection Act. These collected funds may be invested by the Secretary in certain specified accounts.

The Attorney General may bring an action for the recovery of charges that have not been paid in accordance with the Plant Variety Protection Act against any person obligated for payment of such charges under such Act.

The Plant Variety Protection Program is entirely voluntary. It provides patent-like protection for a period of 18 years to developers of new varieties of plants. Fees currently charged to participants in this program are now placed in miscellaneous Receipts of the Treasury.

The Committee recommends that an account be established, in which fees, late payment penalties and accrued interest collected from the account may be deposited. The fee and penalty structure will be established by the Secretary.

In making this recommendation, the Committee realizes that it is important that the fee and penalty schedule not be structured in such a way as to preclude, or discourage participation in the program.

SEC.1033. ANNUAL APPROPRIATIONS TO REIMBURSE THE COMMODITY CREDIT CORPORATION FOR NET REALIZED LOSSES.

Section 1033 amends section 2 of the Commodity Credit Corporation Charter Act to provide for the funding of the operations of the Commodity Credit Corporation by means of a current, indefinite appropriation. This action is being taken to prevent disruptions in producer payments and commodity loan availability from the Commodity Credit Corporation.

SEC.1034. LABELING OF PRODUCTS CONTAINING MEAT AND IMITATION CHEESE.

Subsection (a) of this section amends section 1 of the Federal Meat Inspection Act to provide that a product shall be considered to be misbranded under that Act if--

(1) such product contains meat or a meat food product and includes an ingredient that resembles any variety of cheese for which a standard of identity exists and the imitation and/or cheese alternate is present in the product in a substantial amount (i.e., more than 25 percent of the sum of the cheese and the imitation cheese/cheese alternate component of the product); and

(2) there does not appear prominently on the label contiguous to the product name on the principle display panel the term "contains imitation cheese" or, when authorized by the Secretary, the term "contains cheese alternate".

The Committee intends for the Secretary to approve a common or usual name for the ingredients which purport to resemble dairy cheese. The use of the words "imitation" or "cheese alternate" to distinguish the presence of non-dairy cheese must appear on the label until such time as a common or usual name is developed in an appropriate manner after all interested parties have an opportunity to comment. In determining the appropriate name, the Secretary should give due consideration to all relevant federal regulations and policies such as 21 C.F.R. 101.3(e).

This amendment would not foreclose a manufacturer from disclosing the presence of the imitation cheese or cheese alternate as part of a larger non-misleading description of the product. Finally, the Committee recognizes that manufacturers may develop brand or trade names for these ingredients which may be used in conjunction with the common or usual name.

Subsection (b) of this section provides that the Secretary of Agriculture shall issue regulations implementing these amendments to become effective not later than September 1, 1988. The Secretary shall grant individual requests for temporary extension of the effective date of these amendments, but any such extension shall not last beyond September 1, 1989.

The purpose of this section, as reported by the Committee on Agriculture, Nutrition, and Forestry, is to improve labeling of meat and meat food products, including frozen pizzas, which contain substantial quantities of imitation or cheese alternate ingredients which purport to resemble dairy cheese. The bill accomplishes this purpose by requiring changes in the Secretary's labeling policies for meat food products; specifically requiring prominent labeling whenever a meat food product contains significant amounts of an ingredient which purports to resemble dairy cheese (i.e., more than 25 percent of the sum of the cheese and imitation/cheese alternate component).

This bill is designed to improve the labeling requirements of those products which contain imitation cheese or cheese alternates which purport to resemble dairy cheese. The bill does not require any change in existing standards of identity for meat food products enforced by the Secretary. Further, the bill does not mandate the use of additional quantities of cheese or prohibit the use of imitation or cheese alternate in these products.

By improving labeling requirements, this bill will assist consumers in distinguishing between competing products. The bill is not designed to discourage new and innovative products, such as cheese alternates, which resemble dairy cheese and which are wholesome. In this regard, the legislation does not require any changes to existing regulations and policies such as 21 C.F.R. 101.3 (e). The legislation also directs the Secretary to approve new common or usual names for such products.

In addition, the designation of the ingredient can include other descriptive information as may be appropriate under Federal regulations or policies, such as nutritional claims.

The provision allows manufacturers flexibility by requiring prominent front panel labeling where there is a significant use of imitation cheese or cheese alternates which purport to resemble dairy cheese. More prominent disclosure will be required when the amount of the dairy cheese on the product is less than 75 percent of the total dairy cheese and imitation cheese/cheese alternate component. Where the amount of imitation cheese or cheese alternates that purport to resemble dairy cheese is less than or equal to 25 percent of the total component, its presence must only be declared in the ingredient statement.

The Committee believes that such improved labeling will complement the promotion of dairy products by enabling the consumer to more readily distinguish between products containing 100 percent dairy cheese from those that contain imitation cheese or cheese alternates that purport to resemble dairy cheese in a significant amount. It is anticipated that such labeling changes will increase consumption of dairy cheese in meat food products, hence reducing expenditures under the dairy price support program.

Since this legislation will change the labeling requirements applicable to meat food products, primarily frozen meat pizzas, it provides for a one year phase in period. This period of time is consistent with federal agency handling of mandatory labeling changes not involving health or safety questions. The bill also directs the Secretary to grant an extension of the effective date, on a case-by-case basis for one additional year, to permit companies to make compositional or labeling changes, develop new marketing strategies, or to exhaust existing labeling inventory. Authorizing an extension of the effective date will help minimize any economic hardship to companies which maintain large inventories of labels for certain products.

SEC.1035. ETHANOL USAGE.

This section contains certain findings of Congress concerning the use of ethanol as a source of motor fuel including findings that ethanol can be blended with gasoline to produce a relatively clean source of fuel; ethanol can be produced from grain, a renewable resource that is in considerable surplus in the United States; and an increase in the quantity of motor fuels that contain at least 10 percent ethanol from current levels to 50 percent by 1992 would create thousands of new jobs in ethanol production facilities.

The section provides that it is the sense of Congress that the Administrator of the Environmental Protection Agency should use the authority provided under the Clean Air Act to require greater use of ethanol as a motor fuel.

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Title II

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United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

July 23, 1987

The Honorable Lawton Chiles
Chairman, Senate Committee on the Budget
United States Senate
Washington, DC 20510

Dear Lawton:

Pursuant to the reconciliation directive to Committees under the budget resolution for 1988, I am transmitting draft legislation and committee report language that will result in annual outlay savings of at least $200 million for the next three fiscal years as estimated by the Congressional Budget Office. The House Banking Committee is making a similar recommendation to their respective Budget Committee. I understand this proposal will be sufficient to fulfill our reconciliation obligations.

This legislation would allow the FDIC to establish "bridge banks" as temporary vehicles for dealing with bank failures. The assets and liabilities of the failed bank would be assumed by the bridge bank until such time as the FDIC could arrange for a purchase by another institution. By giving the regulator's more time to find a suitable buyer for the failed bank, the bridge bank proposal will help to reduce the losses to the FDIC that would otherwise have occurred if the failed bank were sold immediatley.

The bridge bank proposal is included in H.R. 27 which is now in conference between the two Banking Committees. Should H.R. 27 be eventually enacted into law with the bridge bank language, there would be no need for it to be also included in the omnibus reconciliation bill.

Sincerely,

Bill

William Proxmire

Section 404. Bridge Banks

This section creates a new vehicle, called a "bridge bank", for dealing with bank failures. This vehicle enables the FDIC to "bridge" the gap between the failed bank and a satisfactory purchase-and-assumption or other transaction that cannot be accomplished at the time of failure.

A "bridge bank" is a new national bank established by the FDIC to take over the assets and liabilities of a failed bank and to carry on its business for a limited time. The FDIC may establish a bridge bank only if it finds that:

(1) the net cost of reorganizing and operating a bridge bank (taking into account that any net profits from the bridge bank must be returned to the shareholders of the failed bank) will not exceed the cost of liquidating the failed bank, including paying its insured accounts; or

(2) the continued operation of the failed bank is essential to provide adequate banking services in its community; or

(3) the continued operation of the failed bank is in the best interest of the depositors of the closed bank and the public.

Although bridge banks have all the powers of other national banks, they do not always have capital. Accordingly, they are excepted from various statutory limits based on bank capital, and instead the Comptroller of the Currency is empowered to set appropriate limits.

The FDIC must dispose of the stock of a bridge bank with two years. The FDIC may, after consulting with the Comptroller of the Currency, extend that deadline for up to one year.

The FDIC may assist the sale or merger of a bridge bank in the same way as any other bank. In addition, the FDIC is specifically authorized to provide assistance to a bridge bank or to any company that will acquire control of a bridge bank.

When a bridge bank has taken over a bank that was eligible for an interstate acquisition pursuant to section 13(f) of the Federal Deposit Insurance Act, the bridge bank remains eligible for an interstate acquisition under the provisions of section 13(f).

Section 405. Conversion from FDIC Insurance to FSLIC Insurance

This section provides that when an FDIC-insured bank converts into an institution that is eligible for FSLIC insurance and applies to the FSLIC for such insurance, the bank's FDIC insurance terminates automatically when the FSLIC insurance begins. The FDIC's existing authority to review and prohibit such conversions is terminated. Under the amendment, however, the FSLIC must notify the FDIC when a bank files an application of that kind, must consult with the FDIC about the application, and must notify the FDIC of the result.

Likewise, when an FDIC-insured bank is acquired by a FSLIC-insured institution, the Federal Home Loan Bank Board and the FSLIC are given sole authority to review and approve the merger; the FDIC's current authority to review and prohibit such mergers is extinguished. Again, the FHLBB or the FSLIC must notify the FDIC when it receives any applications of that kind, must consult with the FDIC about those applications, and must notify the FDIC of the result.

CBO COST ESTIMATE

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

October 21, 1987

Honorable William Proxmire
Chairman
Committee on Banking, Housing and
  Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The Congressional Budget Office has prepared the attached estimate of the budget impact of reconciliation provisions proposed by your committee.

These provisions are contained in Section 503 of H.R. 27, which was signed into law August 10, 1987 (Public Law 100-86). The legislation allows the Federal Deposit Insurance Corporation (FDIC) to establish bridge banks as temporary vehicles for dealing with failing institutions. We expect that these provisions would reduce outlays to the FDIC by an estimated $900 million over the next three years relative to the budget resolution baseline.

Because they have already become law, these provisions were incorporated in the October snapshot for the Balanced Budget and Emergency Deficit Control Act of 1985, as amended. Thus, no further savings would be obtained relative to the October base.

If you wish further details on this estimate, we will be pleased to provide them.

With best wishes,

Sincerely,

Edward M. Gramlich
Acting Director

cc: Honorable Jake Garn
Ranking Minority Member

ESTIMATED BUDGET IMPACT OF RECONCILIATION RECOMMENDATIONS--
SENATE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
(by fiscal year, in millions of dollars)

	Relative to Oct 10 Budget Baseline	Relative to February Budget Resolution Baseline		
	1988	1988	1989	1990
Direct Spending				
Budget Authority	---	---	---	---
Outlays	---	-400	-300	-200

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

Title III

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United States Senate
COMMITTEE ON COMMERCE, SCIENCE,
AND TRANSPORTATION

WASHINGTON, DC 20510-6125

October 21, 1987

The Honorable Lawton Chiles
Committee on the Budget
United States Senate
Washington, DC 20510

Dear Senator Chiles:

We are submitting herewith the legislative changes in programs within the jurisdiction of the Committee on Commerce, Science, and Transportation to achieve savings of $882 million in budget authority and $860 in outlays for FY 1988-1990, as required under the reconciliation instructions contained in House Concurrent Resolution 93, the FY 1988 Budget Resolution.

We believe the enclosed changes will be more than sufficient to meet the prescribed three-year targets.

If you should have any questions, please feel free to contact us.

Sincerely,

Fritz Hollings

Ernest F. Hollings
Chairman

REPORT OF THE COMMERCE COMMITTEE
RECONCILIATION
TRANSFER FEE PROPOSAL
SEC. -3001

The amendment adopted by the Commerce Committee modifies the Fee Schedule section of the Communications Act of 1934 (Section 8). The amendment requires the Federal Communications Commission, prior to the grant of an application to transfer, assign, or otherwise dispose of a construction permit or station license pursuant to section 310(d), to assess and collect a fee from the seller of such permit or license. All persons disposing of Title III radio (spectrum) licenses and construction permits must pay this fee, except as provided for in section 8(d)(1), which exempts such licensees as government and public safety users. The new section 8(g) transfer fee thus applies, for example, to providers of the following services: cellular radio, paging, microwave, satellite, broadcasting, cable (CARS), and MMDS.

The transfer fee shall be assessed on the price paid or on the fair market value as determined by the Commission, whichever is greater, and shall be as follows:

a. Except as provided in (b), the seller shall pay a fee at 2% or, for broadcast permit or license holders, 3% if such holder has willfully violated section 315(e); and

b. If a broadcast station construction permit or broadcast license is disposed of within three years of being acquired, the seller shall pay a fee at 4% (or 5% if the seller has willfully violated section 315(e)), except in any of the following four instances:

(1) the sale of only an FM translator or FM booster station;
(2) a pro forma assignment or transfer of control, where there is no change in the individuals who control or have the power to influence the operation of the station, for example, where the name of the corporation changes;
(3) the sale is necessitated by some unforeseen events, such as the the death or disability of station principals, or financial distress; or
(4) the station is being transferred to an entity controlled by one or more members of a minority group pursuant to the Commission's policies of awarding tax certificates and permitting distress sales under its Statement of Policy on Minority Ownership of Broadcast Facilities, 68 FCC 2d 979 as amended, 52 RR 2d 1301 (1982), and 26 U.S.C. 1071.

In establishing the fair market value of the construction permit or station license, the Commission shall include the price of the permit or license disposed of and all items of value disposed of with such permit or license and used in carrying out the activities for which the permit or license was granted, regardless of whether those other items of value are disposed of between the same persons or in the same transaction or transfer or assignment. The price paid for a station license or permit, including all assets that are part of the operation, should be given great weight in determining the fair market value. However, the Commission must look behind the facade of the transaction to determine that the value is truly at proper market levels.

The "price paid by the person acquiring such permit or license" and the fair market value shall be based upon the price of the license or permit and all assets used in the operation of the communications service that is provided pursuant to that license or permit. Where the communications service could not be provided without the Title III license, such as with cellular, paging, broadcasting, and MMDS, the "price paid by the person acquiring such permit or license" and the fair market value shall, as a general rule, be considered to be the total price of the sale. For example, Pacific Telesis purchased five cellular properties in 1986 for $316 million. The fee should be assessed on this amount, unless the Commission determines the fair market price to be greater. A similar situation would apply with a broadcast station, such as the Murdoch purchase of Metromedia in 1985 for over $2 billion.

Where the sale includes assets other than those used in the operation of the communications service permitted by the license or permit, these other assets shall not be included in the fair market value calculation. For example, while cable systems may have various Title III radio licenses, they comprise a relatively small part of the operation -- which is mainly transmission via wire. The Commission's determination of fair market value should be based only on the licenses and the assets used to operate such licenses and not on the other assets cable television uses in its operations. This example would also be applicable to telephone company operations.

The fee established here shall apply to all applications filed after the date of enactment of this subsection.

The revenues from the fee shall be used for fiscal years 1988 and 1989 to meet the reconciliation obligations of the Commerce Committee. After that, they shall be deposited in a special account to be known as "The Public Broadcasting Trust Fund". Moneys in this account shall be used solely for the Public Telecommunications Facilities Program (section 391) and for the Public Broadcasting Fund (section 396(k)).

To carry out its reconciliation obligations, the Commerce Committee's provision includes two conforming amendments. The first amendment establishes future authorization levels for the Public Telecommunications Facilities Program and for the Corporation for Public Broadcasting (the Public Broadcasting Fund). The level for the Facilities Program is, for each fiscal year beginning with fiscal year 1990, 10% of the amount in the Public Broadcasting Trust Fund or $36,000,000 plus $3,000 multiplied by the difference between the current fiscal year and 1989, whichever is greater. The level for the Corporation is, for each fiscal year beginning with fiscal year 1991, 90% of the amount in the Public Broadcasting Trust Fund or $254,000,000 plus $50,000,000 multiplied by the difference between the current fiscal year and 1990, whichever is greater, except that for fiscal years 1991, 1992, 1993, 1994, and 1995 the total amount shall be increased by an additional $40,000,000 for each fiscal year to be used to replace the satellite interconnection system.

The second amendment is the codification of the Fairness Doctrine. The Committee requires the addition of this amendment in order to establish the proper transfer fee for broadcast stations and to ensure that sufficient revenues are collected. As for justification of the Fairness Doctrine, the Committee relies on its Report (100-34). The following findings are to accompany this provision:

The Congress finds that--

(i) despite technological advances, the electromagnetic spectrum remains a scarce and valuable public resource;

(ii) there are still substantially more people who want to broadcast than there are frequencies to allocate;

(iii) a broadcast license confers the right to use a valuable public resource and a broadcaster is therefore required to utilize that resource as a trustee for the American people;

(iv) there is a substantial governmental interest in conditioning the award or renewal of a broadcast license on the requirement that the licensee ensure the widest possible dissemination of information from diverse and antagonistic sources by presenting a reasonable opportunity for the discussion of conflicting views on issues of public importance;

(v) while new video and audio services have been proposed and introduced, many have not succeeded, and even those that are operating reach a far smaller audience than broadcast stations;

(vi) even when and where new video and audio services are available, they do not provide meaningful alternatives to broadcast stations for the dissemination of news and public affairs;

(vii) for more than thirty years, the Fairness Doctrine and its corollaries, as developed by the Federal Communications Commission on the basis of the provisions of the Communications Act of 1934, have enhanced free speech by securing the paramount right of the broadcast audience to robust debate on issues of public importance;

(viii) the Fairness Doctrine (A) fairly reflects the statutory obligations of broadcasters under that Act to operate in the public interest, (B) was given statutory approval by the Congress in making certain amendments to that Act in 1959, and (C) strikes a reasonable balance among the first amendment rights of the public, broadcast licensees, and speakers other than owners of broadcast facilities; and

(ix) the decision of the Federal Communications Commission in its _Memorandum Opinion and Order_ (FCC 87-266), In re Complaint of Syracuse Peace Council Against Television Station WTVH, Syracuse, New York, is fundamentally flawed, based on faulty evidence and erroneous legal analysis.

TRANSFER FEE PROPOSAL
SECTION-BY-SECTION

Subsection (a) -- Transfer Fee

Subsection 8(g)(1) -- Except as provided in paragraph (2) and in subsection 8(d)(1), the Commission shall assess and collect from the seller of a Title III radio (spectrum) license or construction permit a charge of 2% of the price paid or of the fair market value as determined by the Commission, whichever is greater. This charge shall be increased to 3% in the case of broadcast stations where the seller has willfully violated section 315(e).

Subsection 8(g)(2) -- Except in four narrow cases, for broadcast licenses or permits transferred within three years of being acquired, the fee shall be 4%, or 5% in the case of broadcast stations where the seller has willfully violated section 315(e).

Subsection 8(g)(3) -- For fiscal years 1988 and 1989, the moneys from the transfer fee shall be deposited in the general fund of the Treasury. After that, moneys shall be deposited in a special account to known as "The Public Broadcasting Trust Fund". Annual appropriations to expend moneys in this special account would be required.

Subsection 8(g)(4) -- For the purpose of establishing the fair market value, the Commission shall include the price of the permit or license and all items of value disposed of with such permit or license and used in carrying out the activities for which the permit or license was granted. The Commission shall examine in depth the transfer application to ensure that transaction does not attempt to circumvent the intent of this provision.

Subsection 8(g)(5) -- This provision shall apply to all transfer applications filed [redacted] after date of enactment.

Subsection (b) -- Conforming Amendments

(1) Public Broadcasting Funding -- Public Telecommunications Facilities Program
Section 391 -- This provision authorizes funding for the Public Telecommunications Facilities Program. Beginning in fiscal year 1990, the amount authorized for this program shall be 10% of the funds in the Public Broadcasting Trust Fund or $36,000,000 + ($3,000,000 X (Current Fiscal Year - 1989)), whichever is greater.

(2) Public Broadcasting Funding -- Corporation for Public Broadcasting
Section 396(k)(1)(C) -- This provision authorizes funding for the Corporation for Public Broadcasting. The authorization level for fiscal year 1990 would be the current authorization of $254,000,000 or 90% of the Public Broadcasting Trust Fund, whichever is greater. Beginning in fiscal year 1991, the amount authorized would be 90% of the Trust Fund or $254,000,000 + ($50,000,000 X (Current Fiscal Year - 1990), whichever is greater. In addition, the amount authorized for fiscal years 1991 through 1995 would be increased by $40,000,000 annually to replace public broadcasting's satellite interconnection system.

(3) Fairness Doctrine
Section 315(e) -- This provision is added to codify the Fairness Doctrine.

-- COAST GUARD USER FEES --

This section directs the Secretary of the department in which the Coast Guard is operating to collect receipts from payments by users of Coast Guard services during fiscal years 1988 through 1990.

The Secretary is directed to establish and implement a system for collection of payments based upon sale of Support of Services (SOS) Stamps for specified services and fees to be charged to persons who utilize those services and have not purchased a SOS Stamp.

It is intended that SOS Stamps be sold at modest prices and be designed to serve as both a voluntary means of contributing to the Coast Guard and as a type of insurance, entitling the purchaser to specified services without charge. Those uninsured persons who have not purchased a SOS Stamp would pay fees for the services whenever they utilize them and would, therefore, pay a greater price for the same services.

The Secretary is given discretion to develop several different SOS Stamps, each providing coverage for different classes of services. Stamps and fees for non-emergency as well as other Coast Guard services should be considered and designed to minimize adverse economic effects upon the users as well as upon dependent and related commercial activities. It would not, for example, be appropriate to impose fees upon the barge industry at this time, since such fees would exacerbate its already severe economic depression.

The Secretary is directed to develop, by January 1, 1988, a schedule of fees to be charged to persons who utilize services and have not purchased a SOS Stamp for those same services. The Secretary is not authorized to issue regulations or collect fees under this section for any services for which there is not a corresponding and less expensive SOS Stamp available for sale. The fees are to be established by regulation under the General User Fee Statute (31 U.S.C. 9701). Such fees must, therefore, be set at a level no higher than the actual cost of the service and value to the individual to be charged a fee, and they must satisfy the other requirements of that Statute.

The Secretary is directed to report to Congress by December 1, 1987, prior to implementing the system and again after one year of experience with the system. The Committee intends to monitor the Secretary's efforts closely and to scrutinize the implementation of the system and its effects carefully.

COMMITTEE ON ENERGY AND NATURAL RESOURCES

Title IV

J. BENNETT JOHNSTON, LOUISIANA, CHAIRMAN

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GARY G. ELLSWORTH, CHIEF COUNSEL FOR THE MINORITY

United States Senate
COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, DC 20510

September 30, 1987

The Honorable Lawton Chiles
Chairman
Committee on the Budget
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The enclosed legislation and report are submitted in accordance with the reconciliation instruction contained in H. Con. Res 43, the Concurrent Resolution on the Budget for Fiscal Year 1988. The recommendations of the Committee include changes in existing laws within its jurisdiction to achieve changes in spending authority required for fiscal year 1988, 1989, and 1990.

One note about the Congressional Budget Office cost estimate is necessary. Committee action on subtitle A, the nuclear waste provisions, was predicated on a cost estimate of the savings that would be achieved. The cost estimate was done in consultation and agreement with the Budget Committee staff and the CBO staff. That cost estimate included an assumed "spendout rate" of 50-40-10 for the program that would be applied to authorization savings that would be achieved. After the Committee acted on the nuclear waste provisions, CBO changed its assumptions about the application of that spendout rate to the surprise of the staffs of both Committees. We take exception with that change, and stand by our agreement as to how changes in the nuclear waste program will be scored.

With best wishes,

Sincerely,

James A. McClure
James A. McClure
Ranking Minority Member

J. Bennett Johnston
J. Bennett Johnston
Chairman

Enclosure
cc: The Honorable Pete V. Domenici
Ranking Minority Member

TITLE IV - COMMITTEE ON ENERGY AND NATURAL RESOURCES

The Committee on Energy and Natural Resources held full committee business meetings on July 22, 23, 24, 28, and 29, August 5, and September 16, and 23, 1987, to consider legislation to meet its reconciliation instruction pursuant to H. Con. Res. 93. On September 23, the Committee approved its reconciliation legislation by a vote of 18 yeas and 0 nays, as follows:

YEAS	NAYS
Johnston	
Bumpers*	
Ford	
Metzenbaum*	
Bradley	
Bingaman	
Wirth	
Fowler*	
Conrad*	
McClure	
Hatfield*	
Weicker*	
Domenici*	
Wallop	
Murkowski	
Nickles	
Hecht	
Evans	

*Indicates vote by proxy.

The Committee's recommendations are summarized below.

SUBTITLE A - NUCLEAR WASTE

Subtitle A, the Nuclear Waste Policy Act Amendments Act of 1987, redirects the national nuclear waste program. Significant savings from reduced costs to the nuclear waste management system can be achieved in the near term. The legislation authorizes construction of a monitored retrievable storage (MRS) facility and requires candidate repository sites to be characterized sequentially, rather than in parallel as is provided for under the existing law.

As the Congressional Budget Office (CBO) report on Subtitle A shows, the legislation achieves authorization savings and outlay savings relative to the CBO baseline. As agreed with the Chairman of the Budget Committee, and as discussed during the Committee's markup of the reconciliation legislation, savings from the CBO baseline have subsequently been crosswalked to the Energy and Water Development Appropriation Bill, H.R. 2700, as reported by the Senate Committee on Appropriatons, with the Energy and Natural Resources Committee being credited with the budget savings for purposes of reconciliation. The Budget Resolution assumes that the nuclear waste disposal fund is frozen at FY 1987 levels with budget authority at $499 million and outlays at $458 million. The Energy and Water Development Appropriation Bill reflects the agreed upon crosswalk, with the authorization savings having been subtracted from the freeze level for a total nuclear waste fund appropriation of $360 million in FY 1988.

SECTION-BY-SECTION ANALYSIS

Subtitle A has been reported separately as S. 1668 (S. Rep. 100-159). The contents of that report are hereby incorporated by reference.

SECTION 4001

This section provides that the subtitle may be cited as the "Nuclear Waste Policy Act Amendments Act of 1987".

SECTION 4002

This section amends the Nuclear Waste Policy Act of 1982 (NWPA) by adding a new title IV entitled "Program Redirection". The new title has ten sections as follows:

Section 401

This section contains the findings, purpose and definitions for the title.

The findings include a statement that significant savings from reduced costs to the nuclear waste management system can be achieved in the near term by redirection of the national nuclear waste program to construct a monitored retrievable storage (MRS) facility and to characterize candidate repository sites sequentially, rather than in parallel as is provided for in the Nuclear Waste Policy Act of 1982.

The cost of characterizing candidate repository sites has been estimated at approximately $1 billion per site. Therefore, successful characterization of one candidate site, rather than full characterization of three, will significantly reduce program costs. Based on the record, there is ample reason to believe that at least one of the three candidate sites now under consideration can be successfully characterized.

The construction of an MRS facility, as proposed by the Secretary of Energy, is necessary in the scheme proposed here. Construction of an MRS facility provides a number of advantages. MRS results in cost advantages, improves system flexibility, and provides insurance in the form of backup storage in the event that sequential repository site characterization does not result in an operating repository by 1998, which is the time the

Secretary is obligated to accept spent nuclear fuel under existing contracts with nuclear utilities.

Thus, sequential characterization of candidate repository sites, construction of an MRS facility, and significant budget savings go hand in hand.

A second finding is that the redirection of the program as set forth in this legislation is required to permit the Secretary to carry out in a timely fashion his responsibilities under the NWPA to accept spent nuclear fuel and dispose of it. This legislation provides definitive Congressional direction to proceed with the siting of the facilities the program needs and new authority to assist the Secretary in resolving conflicts involving States, Indian tribes and units of local government in siting those facilities.

Accordingly, a final finding is that it is appropriate for the Federal Government to provide payments to an Indian tribe when a repository or a monitored retrievable storage (MRS) facility is sited on the reservation of the tribe, and, when the facility is not sited on a reservation, it is appropriate to provide payments to the State and to affected units of local government where the repository or MRS facility is sited.

The authority to make these payments provides an opportunity, not available under current law, for significant benefits for a State, tribe or unit of local government from the siting of a repository or an MRS facility. Authority to make these payments provides the potential that a State, tribe or unit of local government might determine that it is advantageous to cooperate in the siting of the needed facilities.

The term "affected unit of local government" is defined for purposes of the new title IV to include, at the discretion of the Secretary, units of local government contiguous to the unit of local government where a repository or MRS facility is sited. The Secretary has the flexibility to designate a contiguous unit of local government as "affected" when the Secretary feels that to do so will promote equity and further the process of facility siting and development.

Section 402

This section directs the Secretary, by January 1, 1989, to select a preferred site for characterization for the first repository.

The Secretary would make the selection from the three sites previously selected for characterization as candidate sites for the first repository: on the Hanford Reservation in Richland, Washington; in Deaf Smith County, Texas; and at Yucca Mountain in Nevada.

The President has already determined that each of these three sites is suitable for characterization as a candidate site for the first repository. No new information or analysis is necessary in order to proceed with full characterization of all three sites. Under section 402, the Secretary is directed to select the most suitable of these three sites for characterization.

In making the selection of one of these sites as a preferred site, the bill directs the Secretary to give primary consideration to the four factors set forth in subparagraphs (1)(A) through (D). These factors are to be considered for the purpose of selecting one site from the three for characterization. The factors supplement the guidelines under section 112 of the Act and supercede the guidelines where inconsistent with them. The guidelines under section 112 are for the purpose of selecting sites for characterization generally. The factors included in this section are intended to be used to select the single site most suitable for characterization.

The Committee is aware that significant ground water or surface water resources, or both, may be present at each of the three sites from which the Secretary must select a preferred site for characterization. The Committee also is aware that several States and Indian tribes have expressed strong concerns about the adequacy of the Secretary's assessment of potential impacts from storage and disposal of nuclear waste on these water resources. The Committee anticipates that in carrying out the purposes of this Act the Secretary will fully consider the presence of surface water or ground water resources, and potential impacts, if any, to those resources.

Subsection (a)(2) directs the Secretary to carry out such activities at the three sites as the Secretary decides will provide useful information for selecting the preferred site. The bill requires that the selection of a preferred site be made by January 1, 1989, and that the Secretary's decisions about information gathering activities will be guided by this selection deadline. Information gathering activities should be structured in such a way not only to provide the greatest amount of useful information but also to ensure that this selection deadline is met.

Subsection (a)(2) also specifies that the Secretary shall not initiate construction of an exploratory shaft facility until such time as a preferred site is selected under this subsection. It is the Committee's understanding that the Department does not intend to construct exploratory shafts during the period between now and January 1, 1989. The Committee felt, however, that a statutory limitation would underscore its intent that exploratory shaft contruction not be initiated prior to selection of a preferred site.

Upon selection of a preferred site, the Secretary is required to take all those actions that normally would have been taken under the first three titles of the Act to characterize the site and to prepare for licensing, construction, and operation of a repository at the preferred site. Activities at the sites not selected would be suspended as soon as possible, in such a way to ensure an orderly close out of site-specific work.

If a preferred site that has been selected by the Secretary is subsequently determined by the Secretary to be unsuitable for a repository, the Secretary must immediately make this determination known to all interested parties, suspend benefits payments under this title, and begin a process of selecting a new preferred site from the sites remaining of those considered under subsection (a). In selecting a new preferred site, the Secretary would repeat within six months the process outlined in subsection (a) for selection of a preferred site, including giving primary consideration in the selection to the same four factors listed in subparagraphs (a)(1)(A) through (D) and otherwise complying with the requirements of this section with respect to the selection process, including, for example, the environmental evaluation required under subsection (f).

Subsection (d) provides that the State in which the preferred site is located and any affected units of local government would be eligible for benefits payments under section 404 of this title.

Subsection (e) states that any decision of the Secretary to select a preferred site under subsection (a), to suspend work on other sites under paragraph (b)(2), or to reject a site chosen as a preferred site that later proves unsuitable under subsection (c) shall be in writing and shall be available to Congress and the public. It is the Committee's intent that these decisions shall be noticed in the Federal Register.

Subsection (e) also describes the process for judicial review of these decisions under subsection (a), paragraph (b)(2), and subsection (c). These decisions shall be subject to judicial review only by the Temporary Emergency Court of Appeals (TECA). Any action for judicial review must be filed within 30 days after public notice of the Secretary's decision. TECA is directed to decide any such case in 60 days. This deadline may be extended by 30 days, and the extension may be renewed twice. The total review time by TECA, therefore, shall be no more than 150 days.

Except as noted below, the grounds for review of these decisions shall be the standard grounds of the Administrative

Procedure Act (5 U.S.C. 706) (APA). The Secretary's decision, therefore, could be found unlawful if found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; contrary to constitutional right, power, privilege, or immunity; in excess of statutory jurisdiction, authority, or limitations, or short of statutory rights; or without observance of procedure required by law. Two additional grounds for review under the APA are not included as grounds for review in this instance because they are inapplicable to the process that would take place. These grounds are: lack of support by substantial evidence on the record of an agency hearing; and claim that the action is unwarranted by the facts to the extent that the facts are subject to a trial de novo by the reviewing court. These grounds are inapplicable because the Secretary's action under this section would not involve adjudicatory or rulemaking hearings on the record and because the review is not intended to involve extensive fact-finding by the reviewing court.

The Committee's objective in allowing judicial review only by TECA is to expedite the process of review. The Committee does not want to stop or delay the process of site characterization of a preferred site because of a prolonged court review. The exclusive right of review by TECA applies only to the Secretary's decisions under subsection (a), paragraph (b)(2) and subsection (c). This provision is not intended to restrict or preclude judicial review of other actions by the Secretary under this section, title, or Act except as expressly provided. Judicial review would apply to other actions in accordance with current law.

The Committee intends that the same process for judicial review under this subsection would be followed if a new preferred site were selected under subsection (c).

Subsection (f) requires the Secretary to prepare a detailed statement of the basis for his selection of the preferred site and to prepare an environmental evaluation as described in subparagraphs (1)(A) through (D). The Committee does not intend the detailed statement or environmental evaluation to be either an environmental impact statement or environmental assessment as required under the National Environmental Policy Act of 1969 (NEPA). Indeed, the environmental evaluation required is not pursuant to NEPA, but rather is specifically authorized and directed by this section as separate statutory authority. The detailed statement and environmental evaluation are documents required solely to support the Secretary's selection of a preferred site under this section. The intent of the environmental evaluation is to make it clear how the Department reached its decision on the preferred site. It is intended to be a comparative evaluation of the sites, which contains information on the relative pros and cons of the preferred site. These documents are not intended as a supplement to the previously-completed environmental assessment of the preferred site published by the Department in May 1986. As such, subsection (f) does not affect in any way any pending litigation on the adequacy of environmental assessments previously published by the Department.

Subsection (f)(2) requires the Secretary to solicit the comments of the National Academy of Sciences (NAS) and to provide an opportunity for public comment before preparing the environmental evaluation required under this subsection. The Committee intends that these comments relate to (a) what information NAS or the public believes should be considered prior to preparation of the environmental evaluation and (b) what information should be contained in the document. The Committee does not intend that a draft of the environmental evaluation be provided for comment by NAS or the public.

Subsection (f)(3) requires the Secretary to preserve all writings, records of meetings, draft reports and studies, and other documents and recordings relating to the selection of the preferred site and to the completion of the environmental evaluation for a period of two years following the date of selection of the preferred site. Subject to existing law, this paragraph also requires the Secretary to make these documents available to the public upon request. The intent of this paragraph is that documents would be available for public inspection for two years after the time of selection of the preferred site. The Committee intends that the availability of documents would be subject to existing laws of disclosure. The Committee does not intend this paragraph to provide any new authority to allow access to or restrictions on disclosure of predecisional documents or information.

The intent of subsection (g) is self-explanatory.

Subsection (h) requires the Secretary to report to Congress, within one year after the selection of the preferred site, on the potential impacts of locating a repository at the site. The potential impacts to be addressed in the report are specified in paragraphs (1) through (14). This list is not intended to be exclusive.

Section 403

This section addresses the siting of monitored retrievable storage facilities. Construction of an MRS facility is not authorized under current law.

Subsection (a) annuls and revokes the Secretary's proposal to locate a monitored retrievable storage facility in Tennessee. Therefore, in carrying out the provisions of this section, the

Secretary is directed to give no presumption or preference to the sites in that proposal by reason of their previous selection.

The Secretary is directed under this section to conduct a survey and evaluation of three potentially suitable sites for a monitored retrievable storage facility in not less than two States between the date of enactment and January 1, 1989. Criteria to be considered in this survey are contained in paragraphs (1) through (6) of subsection (b). The Committee does not intend these criteria to be exclusive.

Subsection (c) provides a mechanism for voluntary siting of an MRS facility. Therefore, the Committee intends the Secretary to make every reasonable effort to find a State or Indian tribe with a suitable site that is willing to accept the facility by January 1, 1989. If successful in locating a suitable site within such a State or on a reservation, the Secretary is authorized to construct and operate an MRS facility consistent with section 141 of the NWPA and in accordance with applicable agreements under the new title IV. To help in the effort to find a suitable site within a willing State or on an Indian reservation, the Secretary is authorized under paragraph (2) of subsection (c) to provide grants to a State, Indian tribe, or unit of local government to support an assessment of the feasibility of siting an MRS facility in its jurisdiction or on its reservation, in the case of an Indian tribe. The Committee intends that the Secretary be afforded discretion in providing grants to States, Indian tribes, or units of local government.

If the Secretary does not select an MRS site within a willing State or on an Indian reservation under the provisions of subsection (c), the Secretary is required under paragraph (2) of subsection (d) to select a site from those surveyed in subsection (b) for an MRS facility. The Secretary's selection of a site under paragraph (2) of subsection (d) shall be on the basis of available information and shall be the site determined by the Secretary to be the most suitable for an MRS facility. This selection of a site shall be made between January 1, 1989, and October 1, 1989.

Subsection (e) provides for a veto by the State or Indian tribe selected to host an MRS facility under paragraph (d)(2). The procedure for notice of disapproval and Congressional review of such a notice is the same as the procedure set forth in current law for a repository.

Subsection (f) requires the Secretary to study the need for and feasibility of one or more monitored retrievable storage facilities in addition to the facility authorized under this section. The study shall examine the desirability of co-locating the site of an MRS facility for spent nuclear fuel from civilian nuclear activities with a site at which substantial volumes of high-level radioactive waste generated from atomic energy defense activities are located. The study shall also include the development of a plan for the management of defense high-level waste in a system that includes one or more MRS facilities capable of storing both high-level radioactive waste and spent nuclear fuel. The Committee intends that this study shall address other issues, as appropriate. The Secretary is required to report to Congress on the results of this study by April 1, 1989. If additional MRS facilities are found to be desirable as a result of this study, the Secretary is required to notify Congress and potentially interested States and Indian tribes and submit to Congress site-specific proposals for construction of additional MRS facilities in accordance with the provisions of section 141.

Subsection (g) provides that a State in which an MRS facility is located and any affected units of local government, or an Indian tribe, in the case that a site is located on a reservation, shall be eligible for benefits payments under section 404.

The intent of subsection (h) is self-explanatory.

Subsection (i) requires the Secretary to conduct a study and evaluation by October 1, 1988, of the use of dry cask storage technology at civilian nuclear power reactor sites for temporary storage of spent nuclear fuel until a repository is capable of receiving such fuel. The intent of the subsection is self-explanatory.

Subsection (j) requires the Secretary to submit to Congress by April 1, 1989, a report describing the potential benefits of designing a system to store spent nuclear fuel for at least 50 years prior to emplacement in a repository compared to the current system being designed for 10-year old fuel. Points to be addressed in the report are contained in subparagraphs (j)(1)(A) through (F).

Neither subsection (i) nor subsection (j) in any way limits, conditions, or qualifies the requirements of this title with respect to siting MRS facilities or geologic repositories.

Section 404

This section describes the conditions for entering into benefits agreements provided for in title IV.

Subsection (a) authorizes the Secretary to enter into benefits agreements with authorized representatives of States and Indian tribes. Benefits agreements must be negotiated in consultation with affected units of local government.

Subsection (b) provides that a benefits agreement can be amended only by mutual consent of the parties and terminated only under section 407.

Subsection (c) requires the Secretary to offer to enter into a benefits agreement with the Governor of the State containing the preferred site for the first repository. None of the three candidate sites selected for characterization for a repository is on an Indian reservation, so the Secretary would not seek to enter into a benefits agreement for a preferred site with an Indian tribe.

Subsection (d) requires the Secretary to offer to enter into a benefits agreement covering an MRS facility with appropriate States or Indian tribes.

Subsection (e) provides that only one benefits agreement can be in effect for a repository and only one for each MRS authorized by Congress.

Subsection (f) provides that decisions of the Secretary under this section are not subject to judicial review.

Section 405

This section describes the content of benefits agreements under section 404.

From the time of execution of a benefits agreement until spent nuclear fuel or high-level radioactive waste is received at the facility, annual payments under an agreement are $20 million for an MRS and $50 million for a repository. Upon receipt of spent fuel or high-level waste at the facility, annual payments would increase to $50 million for an MRS and $100 million for a repository and continue for the life of the facility. No payments shall be made before January 1, 1989. The Secretary may not restrict the purposes for which the payments are used, expect that not less than one-third of any payment must be transferred to affected units of local government.

Subsection (b) requires that a benefits agreement provide for a Review Panel as described under section 406, for waiver of the right of a State or Indian tribe to veto a site under title I of the NWPA, for sharing of relevant licensing information among the parties to the agreement, and for participation of the State or Indian tribe in the design of the repository or MRS. The Committee intends that the State or Indian tribe be allowed to participate in the design of the repository or MRS as specified in paragraph (4) of subsection (b), but the Committee does not intend for State or Indian tribe concurrence to be required in order for the Secretary to proceed with a design or with the preparation of documents.

Subsection (c) provides that benefits payments be made from the Nuclear Waste Fund and states that the signature of the Secretary on a valid benefits agreement shall constitute a commitment by the United States to make payments in accordance with the agreement.

Section 406

This section describes the Review Panel referred to in section 405.

Subsection (a) provides that the Review Panel have seven members: two chosen by the Governor, two by affected units of local government, and three chosen by the Secretary. The Secretary's selections are the panel chairman, a member to represent persons paying into the Nuclear Waste Fund, and a member to represent other public interest.

Subsection (b) specifies the term, compensation, and payment of necessary expenses of members of the Review Panel. Expenses of the panel would be paid from the Nuclear Waste Fund.

Subsection (c) enumerates the duties of the Review Panel.

Subsection (d) requires the Secretary to make available promptly any information requested by the Review Panel or its Chairman.

Subsection (e) exempts the panel from the requirements of the Federal Advisory Committee Act.

Section 407

This section addresses requirements for the siting of a second repository.

Subsection (a) prohibits the Secretary from conducting site-specific activities with respect to a second repository unless these activities are specifically authorized by Congress and money is appropriated for them. This provision takes away the Secretary's authorization to conduct site-specific activities. A subsequent Act of Congress would be required before site-specific activities could be conducted.

Subsection (b) removes the requirement in current law that the Secretary nominate and recommend to the President sites for a second repository and that the President recommend to Congress a site for a second repository.

Subsection (c) requires the Secretary to report between January 1, 2007, and January 1, 2010, on the need for a second repository. The Committee intends that the Secretary be able to conduct whatever non-site-specific work is necessary to complete this report.

Section 408

This section authorizes the Secretary to terminate a benefits agreement if the site covered by the agreement is disqualified for its failure to comply with guidelines and technical requirements established in accordance with current law, or if the Secretary determines that the Nuclear Regulatory Commission cannot license the facility within a reasonable time. A State or Indian tribe may terminate a benefits agreement only if the Secretary disqualifies the site. Decisions made by the Secretary under the section are not subject to judicial review.

Section 409

Subsections (a) and (b) preserve provisions of the NWPA and powers of the Secretary under current law that are not expressly affected by this title.

Subsections (c) and (d) provide that the requirements of the National Environmental Policy Act of 1969 (NEPA) shall apply as provided in the NWPA, except that the provisions of section 114(a)(1)(D) and section 114(f) requiring consideration of three sites for a repository would not apply.

The Committee intends that the selection of a preferred site under section 402(a) of title IV should not be considered a major federal action requiring preparation of an environmental impact statement or an environmental assessment. The Committee does not believe that an additional NEPA statement should be required at the time of selection of a preferred site since an environmental assessment has already been completed for each of the three candidate sites previously selected for characterization and since there is a requirement under current law to prepare an environmental impact statement, following site characterization, prior to the time that a single site is recommended to the President for development as a repository.

The Committee also intends that any other actions of the Secretary under this title shall not be considered major federal actions for the purposes of NEPA compliance except as provided in the requirements of title I.

Section 410

This section limits appropriations for activities under the NWPA to $567 million in fiscal year 1988, $545 million in fiscal year 1989, and $484 million in fiscal year 1990.

SECTION 4003

This section amends the Nuclear Waste Policy Act of 1982 by adding a new section 10 entitled "Reports". The new section 10 requires the Secretary to submit two reports to Congress.

Subsection (a) requires the Secretary to contract with the National Academy of Sciences for a study of the major facets of reprocessing of spent nuclear fuel, including economics, the impact of reprocessing on the potential for the proliferation of nuclear weapons, and the effects of reprocessing on nuclear waste management. The Secretary is required to submit this report to Congress by September 30, 1989.

Subsection (b) requires the Secretary to submit a report to Congress within 270 days of enactment of this section on subseabed disposal of spent nuclear fuel and high-level radioactive waste.

SECTION 4004

This section amends subtitle A of title I of the Nuclear Waste Policy Act of 1982 by adding a new section 126 entitled "Transportation".

Subsection 126(a) requires that spent nuclear fuel and high-level radioactive waste be transported under the program mandated by the NWPA in packages that have been certified by the Nuclear Regulatory Commission according to its regulations. The Committee intends that this requirement apply to shipments of both civilian and defense spent nuclear fuel and high-level radioactive waste that are transported under the program mandated by the NWPA.

Subsection 126(b) requires that the Secretary abide by NRC regulations regarding advance notification of State and local governments prior to transportation of such fuel or waste under the program mandated by the NWPA.

Subsection 126(c) requires the Secretary to provide technical assistance and funds to States for training of public safety officials with respect to transportation of spent nuclear fuel and high-level radioactive waste. It is the Committee's intent that such technical assistance and training will cover procedures for routine transportation as well as for emergency response. Such training and technical assistance should focus on prevention of accidents in transportation as well as emergency response after an accident. The Committee intends that the Department provide technical assistance and funds for training of State and local public safety officials, but the Committee believes that the actual training of local officials should be coordinated at the State level. Technical assistance and funds would be provided to the State, and it would be up to the State to coordinate training for local officials and to determine how funding for emergency response training should be spent. The Committee believes that it should be up to the State to determine the appropriate delineation of State and local responsibility in such matters.

Subsection 126(d) directs NRC to require actual tests of sample full-scale transportation packages prior to certifying any package design for the transportation of spent nuclear fuel or high-level radioactive waste under subtitle A or subtitle C of title I of the NWPA.

Subsection 126(e) directs NRC to conduct a survey of the packages for transportation or disposal of spent nuclear fuel or high-level radioactive waste used by other nations. Based on that survey, NRC shall submit a report to Congress by January 1, 1989, that describes foreign designs and comments on the potential for such designs to meet or exceed applicable NRC regulations or standards.

SECTION 4005

Section 4005 amends the repository site approval process under title I of the Nuclear Waste Policy Act of 1982 in two respects.

Subsection 4005(a) amends section 114(a)(1) of the NWPA by adding a new subparagraph (I). This subparagraph provides that any recommendation to the President of a site for development of a repository under section 114(a) be accompanied by a statement by the Secretary, after consultation with the Secretary of Defense, that construction and operation of a repository at that site would not seriously jeopardize national security by reason of interference with national defense activities nearby.

Subsection 4005(b) amends section 116 of the NWPA by adding a new subsection (e) to provide certain adjacent States with the same rights and opportunities to participate in the repository siting process as a State containing a candidate site under the existing Act. The adjacent States included under this subsection would be those that both border on the State in which the candidate site is located and lie contiguous to a river, waterway, or acquifer whose flow, as determined by the Secretary of Interior, passes adjacent to or underneath the site, and continues downstream or down gradient to the bordering State.

The Committee intends the Secretary of the Interior shall be the arbiter with respect to whether an adjacent State lies contiguous to a river, waterway, or acquifer whose flow passes adjacent to or underneath the candidate site, and continues downstream or down gradient to such adjacent State. The

Committee intends that the direction of the flow of the river, waterway, or acquifer shall be the important factor in determining the rights of adjacent States. For example, in a case where an acquifer underlies State A, which contains a candidate site, and also underlies a State on its eastern border and a State on its western border -- if the acquifer flows to the east, then the State to the east would be entitled to rights as an adjacent State but the State to the west would not.

The Committee intends that this subsection shall apply only with respect to the siting of a repository and shall not apply with respect to siting of an MRS.

SECTION 4006

Section 4006 amends subtitle A of title I of the Nuclear Waste Policy Act of 1982 by adding a new section 127. This section requires the Secretary, in siting federal research projects, to give special consideration to proposals from States where a repository is located.

SUBTITLE B - FEDERAL ONSHORE COMPETITIVE OIL AND GAS LEASING ACT OF 1987

SECTION-BY-SECTION ANALYSIS

Subtitle B has been ordered reported separately as S. 1730 (S. Rep. 100-188). The contents of that report are hereby incorporated by reference.

SECTION 4101

Section 4101 states the short title.

SECTION 4102

Subsection 4102(a) amends paragraph 17(b)(1) of the Act of February 25, 1920, to direct the Secretary of the Interior to lease lands to be leased to the highest responsible qualified bidder by competitive bidding as long as the highest bid equals or exceeds a national minimum acceptable price established by the Secretary which is at least $10 per acre. This section specifically directs that no evaluation of the value of the lands shall be conducted. Lease sales shall be held for each state where eligible lands are available at least every two months.

Lands for which no bids are received or for which the highest bid is less than the minimum acceptable price shall promptly be offered within 30 days for leasing without competitive bidding and shall remain available for leasing without competitive bidding for a period set by the Secretary not to exceed three years after the competitive lease sale. The remaining provisions of the subsection are self-explanatory.

Subsection 4102(b) amends subsection 17(c) of the Act of February 25, 1920, to provide if lands to be leased are not leased by competitive sale under paragraph 17(b)(1) or are not subject to competitive leasing under paragraph 17(b)(2), the first qualified applicant shall be entitled to a lease of such lands without competitive bidding. Lands to be leased under this provision are to be made available at least every two months. Leases shall be issued within 60 days of the date on which the Secretary identifies the first qualified applicant. It is the Committee's intent that where there is substantial activity or interest in particular lands, the Secretary of the Interior will determine an orderly means of prioritizing applicants.

Subsection 4102(c) amends Section 17(c) of the Act of February 25, 1920, to provide that lands posted for sale under paragraph (b)(1) for which no bids were received or for which the highest bid was less than the minimum acceptable price and for which at the end of the period prescribed by the Secretary under paragraph (b)(1) no lease has been issued and no lease application is pending under paragraph (c)(1) shall again be available for leasing only in accordance with paragraph (b)(1).

Land in any lease, including leases existing on the date of enactment, which lease terminates, expires, is canceled, or is relinquished shall again be available for leasing in accordance with paragraph (b)(1).

Section 4102(d) amends subsection 17(d) of the Act of February 25, 1920, to provide that all leases to be issued shall be conditioned upon payment of a rental of not less than $1 per acre for each year payable in advance. It is the view of the Committee that the Secretary should consider raising the rental to $1.25 per acre for those leases for which rental is currently $1 per acre. The section requires payment of a minimum royalty of not less than $1 per acre in lieu of rental payable at the expiration of each lease year beginning on or after a discovery of oil or gas in paying quantities, except that no minimum royalty shall exceed the rental rate that would have applied before discovery.

Subsection 4102(e) amends subsection 17(e) of the Act of February 25, 1920, to provide that in addition to the authority granted to the Secretary under section 39 of the Act of February 25, 1920, the Secretary is authorized to suspend a lease under circumstances specified in the provision, and if such suspensions occur, the term of such lease shall be extended by adding any such suspension period thereto.

SECTION 4103

Section 4103 amends section 30a of the Act of February 25, 1920, to allow the Secretary to disapprove assignments of a separate zone or deposit under any lease, of a part of a legal subdivision, or of less than 640 acres outside Alaska or of less than 2560 acres within Alaska, unless the assignment constitutes the entire lease or is demonstrated to further development of oil and gas. The Secretary is directed to promptly process requests for assignment or sublease. Except where the assignment or sublease is not in accordance with applicable law, approval shall be given within 60 days of the date of receipt of the request for approval.

SECTION 4104

Section 4104 amends subsection 31(b) of the Act of February 25, 1920, to provide that any lease issued under that Act shall be subject to cancellation by the Secretary after 30 days notice upon the failure of the lessee to comply with any of the provisions of the lease, unless or until the leasehold contains a well capable of production of oil or gas in paying quantities, or the lease is committed to an approved cooperative or unit plan or communitization agreement which contains a well capable of production of unitized substances in paying quantities. This amendment is necessary to conform the lease cancellation provisions to the changes being made in the leasing provisions.

SECTION 4105

Section 4105 adds a new section 43 to the Act of February 25, 1920, to provide that actions taken by the Secretary to develop regulations and procedures for a competitive oil and gas leasing program or to hold particular lease sales are not subject to the requirements of Section 102(2)(C) of the National Environmental Policy Act (NEPA). The section does not otherwise affect the applicability of NEPA. Thus, lease issuance will continue to be subject to NEPA.

SECTION 4106

Section 4106 amends the Alaska National Interest Lands Conservation Act to make certain leasing in Alaska consistent with that of the lower 48 States. Specifically, the favorable petroleum geological province (FPGP) is eliminated and replaced with the provisions of section 4102.

SECTION 4107

Subsection 4107(a) is a "grandfather" provision for noncompetitive applications and offers and competitive bids pending on the date of enactment of the Federal Onshore

Competitive Oil and Gas Leasing Act of 1987. Subsection 4107(b) provides for a competitive bidding test for certain specified lands. Subsection 4107(c) provides that except as provided in subsections (a) and (b), all oil and gas leasing after the date of enactment is to be conducted in accordance with the provisions of this Subtitle.

SECTION 4108

Subsection 4108(a) provides that lands available for noncompetitive leasing on the day prior to enactment and not subject to the exclusions set forth in subsection (b) shall remain available for leasing without competitive bidding by the first qualified applicant. Subsection 4108(b) sets forth lands to which the section does not apply. The Secretary is to publish a list of certain of these excluded lands within 60 days of enactment. Subsection 4108(c) provides that authority to issue leases as provided in the section expires twenty-four months after the issuance of final regulations implementing this Subtitle. Subsection 4108(d) provides that leases issued pursuant to this section are to be subject to the provisions of the Act of February 25, 1920, as amended by this Subtitle.

SECTION 4109

Subsection 4109(a) requires the Secretary to issue final regulations implementing this Subtitle within 60 days after the date of enactment. The remaining provisions of the section are self-explanatory.

Subsection 4109(b) provides that the Secretary shall hold at least one competitive lease sale pursuant to section 4102 prior to issuing implementing regulations. Sale procedures shall be established in the notice of sale. The sale shall include tracts which otherwise would have been posted for filing of simultaneous applications pursuant to 43 CFR Subpart 3112. The Secretary may also include tracts which otherwise would have been posted for competitive sale pursuant to 43 CFR Subpart 3120 and tracts which received over-the-counter offers pursuant to 43 CFR Subpart 3111 between July 1, 1987, and the date of enactment. The Secretary may hold additional sales if he considers it necessary prior to the issuance of final regulations. The remaining provisions of the subsection are self-explanatory.

SECTION 4110

Section 4110 adds a new section 41 to the Act of February 25, 1920, which provides specific authority to combat certain unlawful practices.

Subsection 41(a) establishes that those who make certain misrepresentations to the public incur liability under the section. Subsection 41(b) establishes liability for organizing or participating in schemes, arrangements, plans, or agreements to circumvent the provisions of the Act or its implementing regulations.

Subsections 41(c) and 41(d) contain the penalty provisions. Subsection (c) provides that the Attorney General shall institute a civil action against any person who, given the nature of the intended recipient of the communication, knew or should have known he or she was violating subsection (a) or (b). Subsection (c) provides for a civil penalty of not more than $100,000 for each violation and other appropriate remedies such as a ban on participation in the leasing program.

Subsection 41(d) provides for criminal penalties for knowing and willful violations of not more than $500,000 for each violation and imprisonment for not more than five years or both.

Subsection 41(e) provides that when a corporation or other entity is subject to civil or criminal action under this section, any officer, employee or agent of such corporation or entity who authorized, ordered or carried out the proscribed activity shall be subject to the same action. Also, whenever an officer, employee, or agent of a corporation or other entity is subject to civil or criminal action under this section for activity on behalf of the corporation or entity, the corporation or entity is subject to the same action, unless the action was taken without the knowledge or consent of the corporation or entity.

Subsection 41(f) provides all remedies, penalties, fines, and imprisonment are both concurrent and cumulative, and are in addition to any other remedies provided by law.

Subsection 41(g) authorizes States to bring civil actions under subsection (c) in Federal court. A State is required to notify the United States of any enforcement action in order to facilitate coordination. The State retains all fines collected by that State, except where a joint action is brought by the Attorney General and the State, by more than one State, or by the Attorney General and more than one State, civil penalties recovered are to be shared by the parties bringing the action in accordance with a written agreement entered into prior to the filing of the action. Nothing in the Section is to deprive a State of jurisdiction to enforce its own criminal and civil laws. The remaining provisions of the subsection are self-explanatory.

SECTION 4111

Section 4111 amends section 35 of the Act of February 25, 1920, by adding the requirement that in determining the amount of payments to States under section 35, the amount of such payments shall not be reduced by any administrative or other costs incurred by the United States.

SECTION 4112

Section 4112 requires the Secretary to submit annually a report including certain specified information to facilitate Congressional monitoring.

SECTION 4113

Section 4113 amends subsection 17(a) of the Act of February 25, 1920, to provide that the Secretary of the Interior may not issue any oil and gas lease under the Act of February 25, 1920, on any lands administered by the Secretary of Agriculture through the Forest Service without consultation with the Secretary of Agriculture. The Committee is aware that this provision does not apply to lands leased under the Mineral Leasing Act for Acquired Lands (30 U.S.C. 351 et seq.). That Act requires the Secretary of Agriculture to consent to mineral leasing on lands covered by that Act which are administered by the Secretary of Agriculture.

Section 4113 also amends subsection 17(a) of the Act of February 25, 1920, to require that the Secretary shall not issue a lease or leases or approve the assignment of any lease or leases under the terms of section 17 of the Act of February 25, 1920, to any person, association, corporation, or any subsidiary, affiliate, or person controlled by or under common control with such person, association, or corporation, where any such entity has failed to reclaim a lease tract as required by the terms and conditions of the lease.

SUBTITLE C - PARK SYSTEM ADMISSION FEES

Subtitle C includes the text of H.R. 1320, as amended (S. Rep. 100-86). The contents of that report are hereby incorporated by reference. The only difference between H.R. 1320, as reported, and Subtitle C is a new section 4202(c) to make the recreation fee revenues subject to appropriation for fiscal years 1988, 1989, and 1990. Thereafter fee revenues would be made available without appropriation.

SECTION-BY-SECTION ANALYSIS

SECTION 4201

Section 4201 provides that this subtitle may be referred to as the "Land and Water Conservation Fund Act Amendments of 1987".

SECTION 4202

Section 4202(a)(1) authorizes an increase in the Golden Eagle Passport from $10 to $25.

Section 4202(a)(2) authorizes the establishment of an annual admission permit for a specific park or group of parks at a fee not to exceed $15. The annual admission permit would carry the same terms and conditions as the Golden Eagle Passport except that the permit would only be applicable to the park or parks designated at the time of purchase.

Section 4202(a)(3) provides that the single-visit permit at any designated national park unit shall not exceed $5 per vehicle for those entering by private noncommercial vehicle and $3 per person for those entering by other means.

The Committee seeks to assure that entrance fees are maintained at a fair and reasonable level. It is the Committee's intent that such fees shall not dissuade use of national park units by the public. The $5 per vehicle and $3 per person are the maximum that can be charged. The Committee fully expects the National Park Service to be able to justify the proposed entrance fee at any particular national park unit based on the criteria contained in Section 4(d) of the LWCF Act (including, but not limited to, consideration of the public policy or interest served, the benefits to the recipient and the differences in recreational opportunities offered at individual park units) and set the fee accordingly within the maximums contained in this legislation.

The Committee understands and concurs in their NPS policy of permitting Native Americans (including Hawaiian Natives) free entry into NPS fee areas for religious purposes.

The Committee is also aware that some controversy has arisen regarding the charging of an entrance fee for those persons who cross park lands in a vehicle for non-recreational, non-commerical, commuting purposes. This issue has been especially contentious at Zion National Park and Cedar Breaks National Monument in Utah where the Park Service began charging a fee for this purpose earlier this year. The Service has since discontinued this practice. This issue has also been raised at Hawaii Volcanoes National Park, Hawaii, which lies between the City of Hilo on the Island of Hawaii and the Island's Western "Kona" Coast.

The Committee is opposed to charging fees in these circumstances at national parks in Utah, Hawaii, or elsewhere. The Committee has received a letter from the National Park Service clarifying its position on this issue. Director Mott has also written to Senator Matsunaga concerning the situation at

Hawaii Volcanoes. According to these letters, the policy of the National Park Service is not to charge admission fees for non-recreational, non-commerical traffic travelling through units of the National Park System. This policy is the same regardless of whether the road is a component of the Federal-Aid Highway System (which is specifically prohibited in the existing provisions of the Land and Water Conservation Fund Act) or a road built and maintained with funds of the National Park Service. The Committee concurs in this policy and plans to monitor its implementation carefully.

Section 4202(a)(4) provides that an admission fee may not be charged at any unit of the National Park System which provides significant outdoor recreation opportunities in an urban environment and to which access is publicly available at multiple locations. The Park Service has identified the following units of the system which meet these criteria: Chattahoochee River, Chickasaw Cuyahoga Valley, Gateway, Golden Gate, and Santa Mountains NRA's; Indiana Dunes National Lakeshore; and Greenbelt Park.

Section 4202(a)(5) paragraph (6) directs that within 60 days of enactment the Secretary shall submit to the House Committee on Interior and Insular Affairs and the Senate Committee on Energy and Natural Resources a list of parks showing the admission fee proposed to be charged at each unit. The legislation requires that the Secretary establish and include in the report an explanation of the guidelines used in applying the fee criteria contained in Section 4(d) of the LWCF Act. Further, it requires a 60-day notification period to the Committee before any changes in the report can take effect.

The Committee expects the Secretary in his report to the Committee to be fully able to justify both the imposition of an entrance fee at a specific park unit, as well as the level of the fee proposed to be charged.

Section 4202(a)(5) paragraph (7) specifies that no admission fee may be charged at any unit of the National Park System for admission of any person 16 years of age or less.

Section 4202(a)(5) paragraph (8) provides for free admission to organized school groups or outings conducted for education purposes by schools or other bonafide institutions.

Section 4202(a)(5) paragraph (9) prohibits the imposition of an entrance fee at Statue of Liberty National Monument, U.S.S. Arizona Memorial and Independence National Historical Park.

Section 4202(a)(5) paragraph (10) directs the Secretary to provide for an annual entrance fee-free day at each unit of the park system charging an entrance fee. This day is to occur during periods of high visitation.

Section 4202(a)(5) paragraph (11) authorizes a single visit entrance fee of up to $10 per vehicle or $5 per person at three specific park units: Yellowstone, Grand Teton, and Glacier National Parks. In the case of Yellowstone and Grand Teton, persons paying an entrance fee at one park need not pay to enter the other.

For purposes of distributing revenues from fee receipts collected at Yellowstone and Grand Teton, the Committee expects the funds to be allocated separately between the two park units on the basis of attendance at the respective unit.

Section 4202(b) modifies Section 4(f) of the LWCF Act to eliminate a duplicative and inconsistent provision regarding the creation of a special account and use of funds from that account for outdoor recreational purposes.

Section 4202(c), paragraph (i) directs that, except as otherwise specifically provided by law, all receipts from fees collected pursuant to the Land and Water Conservation Act by any Federal agency shall be covered into a special account to be available, subject to appropriation, further for resource protection, research, interpretation and maintenance at outdoor recreation facilities managed by the particular agency.

A specific provision was included in the substitute directing that monies collected by the Bureau of Land Management from the issuance of permits for water-based recreational activities are to be used by that agency specifically for the on-the-ground enhancements of such activities.

Amounts covered into the special account established for the National Park Service shall be available for the following purposes: (1) for receipts from entrance fees, the funds are limited to resource protection, research, and interpretation at units of the National Park System and (2) for receipts derived from user fees, funds are available for resource protection, research, interpretation and maintenance related to resource protection at units of the National Park System.

It is the Committee's strong belief that fee receipts should not be used as an offset against general appropriations. Fee receipts are being provided to the collecting agency as a supplement to the funds normally appropriated and should not be used as a substitute for all or a portion of those funds.

This paragraph also includes a provision directing that, after October 1, 1990, these fee revenues credited to the special account are to be made available to the land managing agency without further appropriation.

Section 4202(c) paragraph (j) provides that funds available to the National Park Service from the special account established by the Act are to be allocated on the basis of 35 percent of the funds to all units of the National Park System based on each unit's portion of operating expenses; 50 percent to units collecting fees based on each collecting unit's proportion of total fee collections; and 15 percent allocated to park units by the Director on the basis of need.

Under this distribution system, all fees collected are to be returned to individual park units to enhance operational and resource protection efforts. The formula is intended to ensure that non-collecting park units receive a fair and reasonable portion of the fee receipts, while at the same time providing an extra measure of funds to those units where fees are actually collected.

Section 4202(c) paragraph (k) authorizes the use of volunteers to collect fees and sell permits, subject to the volunteers being bonded and receiving adequate training. It permits the Secretary to enter into agreements with third parties to sell at no cost to the government, annual admission permits (including the Golden Eagle Pasport). It requires that the cost of such permits shall be paid in advance to the government.

The Committee received testimony from the National Park Service regarding the possibilities of marketing annual admission permits through third parties. Within the confines of the legislative language, the Committee believes that this would be an acceptable way of advancing the permits availability to the public.

Section 4202(c) paragraph (l) permits the Secretary, in those parks with transportation systems, to impose a transportation fee in lieu of an entrance fee. It provides a formula for distributing funds collected at parks with a transportation fee.

At present, this provision is primarily applicable to Denali National Park in Alaska. Under the Committee substitute, admission fees are not permitted at Denali or any other unit of the park system in Alaska since the substitute did not repeal the prohibition on such fees contained in the Alaska National Interest Lands Conservation Act of 1980.

The Park Service does, however, charge for a transportation service at Denali - a shuttle bus system from the Visitor's Center to Wonder Lake. This provision would permit the Park Service to charge for this service at a rate not to exceed the maximum admission fee provided in subsection (a).

Section 4202(c) paragraph (m) limits the amount of the admission fee that may be charged at units of the park system where access to the park is provided, for a fee, by a concessioner. These situations most commonly involve island parks where access is by boat. This provision assures that the combined entrance fee and the fee charged by the concessioner for transportation will not exceed the maximum admission fee under subsection (a). The Committee is aware that the practical effect of this provision will be to eliminate admission fees at units of the system where access is provided by a concessioner since most of the concessioner fees currently exceeed the maximum fee permitted under this subsection (a).

Section 4202(d) strikes the provision of Public Law 96-514 that requires all receipts from recreation fee collections be deposited in the Land and Water Conservation Fund.

Section 4202(e) repeals the freeze on entrance fees to National Park units contained in Section 402 of the Act of October 12, 1979.

Section 4202(f) authorizes a 3 year study and report by the Secretary on the feasibility of adjusting entrance fees to encourage alternative transportaton usage and visitation at off-peak times.

SECTION 4203

Section 4203(a) reauthorizes the Land and Water Conservation Fund for a period of 25 years at $1 billion annually.

SUBTITLE D - TONGASS TIMBER SUPPLY FUND

Subtitle D makes the Tongass Timber Supply Fund subject to appropriation for fiscal year 1988 and 1989.

The Committee's action is for two years only and is taken solely for budget reconciliation purposes during that period. It does not constitute an expression by the Committee for or against legislation concerning Section 705 of the Alaska National Interest Lands Conservation Act of 1980 or the Tongass National Forest which now is or may come before the Committee. The Committee recognizes that it has yet held no hearings on the Tongass and Section 705 of ANICLA and that to make such an expression for or against such legislation now would be premature.

MINORITY VIEWS OF SENATOR PETE V. DOMENICI

I voted against including the nuclear waste provisions in this reconciliation bill because I believe reconciliation is an inappropriate vehicle for a complete revision of the Nuclear Waste Policy Act. The Budget Act limits debate on a reconciliation bill to 10 hours and amendments must meet stringent germaneness requirements. Therefore, the full Senate will not have an opportunity to fully debate or even amend this important legislation.

I also have serious doubts whether the alleged savings will be achieved. If the Budget Committee gives this Committee credit for the reduction in the authorization of appropriations for the nuclear waste program, it will be breaking the rules for estimating savings in a reconciliation bill. I am particularly concerned about the alleged out-year savings, since this bill will not implement the savings claimed in the budget resolution for the next three years. In sum, reconciliation should serve as a vehicle to install permanent budget savings in law, and not as a vehicle to reauthorize programs.

Chic Hecht

ADDITIONAL VIEWS BY SENATOR HECHT

Although I did not oppose the Committee's overall package on budget reconciliation, I remain vigorously opposed to the part of that package relating to the Energy Department's high level nuclear waste program. I do not think that deep geologic disposal of fresh spent fuel is the best approach for America. I therefore continue to oppose this nuclear waste initiative either as a freestanding bill, or as part of budget reconciliation.

The twelve amendments which I offered to this measure at markup were designed to both encourage alternatives to deep geologic disposal, and to improve the deep geologic disposal program, because, for the time being at least, that program is the one mandated by law.

Although the Committee accepted all of my amendments in one form or another, I am still troubled by the timing and the basic thrust of this legislation. I do not feel it is appropriate to try to solve this very complex policy problem under the tight schedule and rules that govern the budget reconciliation bill. I do not believe it makes sense to proceed now when the US Court of Appeals in Boston just rejected the Environmental Protection Agency standards that are to be used to determine whether or not a repository site is adequate. Why instruct the Department of Energy to choose a site to characterize when they do not even know what they are supposed to look for, when they don't have any standard to use in evaluating the information they collect?

Finally, I think sequential characterization is a bad idea. Many people fear that if their state is selected as the preferred site, then their state is likely to get railroaded. The track record of the Energy Department over the last few years tends to aggravate these fears.

The legislation and the amendments I have introduced are intended to force DOE and the Congress to more fully examine alternatives to deep geologic disposal of relatively fresh spent fuel. Several of these alternatives would seem to be safer, less expensive, and more scientifically sound.

Some people in Nevada question my active and constructive participation in the markup of this bill. They would have preferred me to act as an obstructionist. Filibustering would certainly have been easier and politically expedient, but, as is very clear from the vote which reported this bill out of Committee, it would have been a losing proposition and accomplished nothing in the long run for the people of my state or the country.

By participating in the Committee's deliberations, by succeeding in attaching my amendments to this legislation even though I oppose it, Nevada and every other state that is being considered for a repository or a monitored retrievable storage facility, or lies along a transportation route to such a facility, comes out ahead. Even if this particular bill is not enacted into law, the Committee is on record as accepting my amendments.

One of my amendments that was accepted by the Committee calls for a feasibility study of reprocessing spent fuel, particularly aged spent fuel. There is reason to believe that it is far cheaper to reprocess fuel that has been aged for several decades, than it is to reprocess fresh spent fuel. The combination of recovering unfissioned uranium and plutonium to reuse as fuel, and the reduced cost of reprocessing material that has cooled for several decades, may make reprocessing economically feasible. This approach is especially appealing when one considers that reprocessing could postpone the need for a repository for decades beyond the current schedule, thereby relieving the ratepayers of this otherwise pressing financial burden.

Another amendment accepted by the Committee would require that only packages certified by the Nuclear Regulatory Commission be used in moving waste to a MRS or a repository. The Energy Department has recently made a policy decision in this regard with respect to the repository, but I feel the public needs the guarantee that can only be given by statutory language.

Local governments located along waste transportation corridors need to be trained in how to deal with routine and emergency situations associated with the transportation of waste materials. The training should be provided with federal funds, since federal activities create the need for the training. The Committee accepted an amendment I offered to accomplish this.

The procedures used in the testing of waste packages have not generated a great deal of confidence. The Committee accepted an amendment I offered to make sure that before a package design is licensed by the Nuclear Regulatory Commission, a prototype of that design will have passed actual tests specified by the Commission.

Should a site be characterized and eventually chosen for a repository, it is essential that the people of the affected state have first-hand knowledge of the quality of the research and construction work taking place at the location in question. The

Committee accepted an amendment I offered that would provide for the necessary on-site oversight through a state-hired representative. Federal funds would pay for this activity.

The Air Force conducts highly sensitive activities in the vicinity of Yucca Mountain, from Nellis Air Force Base. The Nevada Test Site, which includes a portion of Yucca Mountain, is the location of a vitally important weapons testing program, which might easily affect the safety of a nearby repository, or the construction and operation of a repository might affect the security of the weapons testing operations. The Committee accepted an amendment which I offered which would require the Secretary of Energy to consult with the Secretary of Defense and assure the President that the choice of a repository would not jeopardize the national security by interfering with important national defense activities being undertaken near a repository. I would expect that if the Secretary of Energy cannot offer such assurances, then he would necessarily choose another site for a repository.

Subseabed disposal of nuclear waste has been the subject of an international research effort for many years. The federal government made the mistake of not funding our share of this work in fiscal year 1987. I think this was a serious mistake. I offered an amendment to give subseabed disposal research a higher profile in the Energy Department, and to remove it from that part of the organization that is singlemindedly pursuing deep geologic disposal. While the Committee chose to modify my amendment before accepting it, I am still pleased that the Committee, for the first time, has chosen to formally and explicitly express an interest in this promising alternative to deep geologic disposal. This is clearly a step in the right direction, and I will continue to push for a renewed American involvement in this research.

The Nevada State legislature recently passed a resolution, which was signed by the governor, which presented a list of items for which Nevada would seek compensation from the federal government in the event a repository were located in the state. I offered, and the Committee accepted, an amendment which directs the Secretary of Energy to review and comment on the financial obligations of the United States with regard to the list.

Whichever state ends up with a repository, should also receive preferential consideration with regard to siting Energy Department research projects, including, but not limited to, the Superconducting Supercollider. The Committee accepted an amendment which I offered to make sure that the state which gets the repository also gets special consideration for desirable research projects.

I strongly believe that it is unsafe and unwise for this country to transport and dispose of large quantities of fresh spent fuel. From an engineering perspective, from an economic perspective, and, most importantly, from a safety perspective, we should take a hint from other nations and store spent fuel for several decades before considering permanent disposal. While the Committee rejected my amendment to require above-ground storage for fifty years, I am pleased that the Committee accepted the amendment I offered with Senator Evans to require a study of the advantages of such longterm storage. I look forward to resuming the discussion of the value of longterm storage once the required study is completed.

European nations have adopted casks for the transportation and permanent disposal of spent fuel and high level radioactive waste which have been described as superior to those being used, or that are planned to be used, in this country. The Committee accepted my amendment which requires a review of the foreign designs to see if they might be superior. If there are better casks out there, we either ought to use them in this country, or make our own to those standards.

Finally, notification of waste shipments has been a recurring problem for state and local governments. In one instance, the

Governor of Nebraska stopped a train carrying waste at the state border, because he did not feel he had received adequate notice of its movement. I believe this is a ridiculous situation, and offered an amendment to make sure that the Energy Department abides by the notice requirements specified by the Nuclear Regulatory Commission.

As a group, I believe these amendments substantially improve a fundamentally flawed program. Unfortunately, I must hold firm to my conclusion that the program is still fundamentally flawed. I therefore oppose this legislation.

CBO COST ESTIMATE

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

September 30, 1987

Honorable J. Bennett Johnston, Jr.
Chairman
Committee on Energy and Natural Resources
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The Congressional Budget Office has prepared the attached cost estimate for the Resolution of the Committee on Energy and Natural Resources of September 23, 1987, containing the committee's recommendation for inclusion in the Budget Reconciliation Act of 1988.

If you wish further details on this estimate, we will be pleased to provide them.

With best wishes,

Sincerely,

Edward M. Gramlich
Acting Director

cc: Honorable James A. McClure
Ranking Minority Member

CONGRESSIONAL BUDGET OFFICE

COST ESTIMATE

September 30, 1987

1. BILL NUMBER: Not yet assigned

2. BILL TITLE:

   Reconciliation recommendations of the Senate Committee on Energy and Natural Resources.

3. BILL STATUS:

   As agreed to by the Senate Committee on Energy and Natural Resources on September 23, 1987.

4. BILL PURPOSE:

   Subtitle A incorporates the text of S. 1668, the Nuclear Waste Policy Act Amendments Act of 1987. This subtitle amends the Nuclear Waste Policy Act of 1982 and redirects the nuclear waste program by making major changes in the site characterization process for the permanent geologic repository, by authorizing a monitored retrievable storage (MRS) facility to prepare and package spent fuel before shipment to a permanent repository, by authorizing benefit payments to affected states and Indian tribes, and by delaying work on a second repository. It also requires the Department of Energy (DOE) to conduct studies of nuclear waste issues and makes various other changes in the act.

   Subtitle B incorporates the text of the Federal Onshore Oil and Gas Leasing Act of 1987 as ordered reported by the Senate Committee on Energy and Natural Resources, July 29, 1987. This subtitle would require that, with some specific exceptions, all federal lands made available for oil and gas leasing be offered initially on a competitive basis. Bids would be set at a minimum of at least $10 per acre. Lands not leased competitively--those that fail to receive the minimum bid in a competitive sale--would be available for noncompetitive leasing for three years. After that time, they would again be available only through the competitive process.

   Subtitle C would revise provisions in the Land and Water Conservation Fund Act relating to recreation fee collection, distribution and use. This subtitle would also increase permanently the statutory maximum price that may be charged for Golden Eagle Passports and for entrance fees to units of the National Park Service (NPS). Additional new fees for other services and annual admission would also be permitted. All fees collected under the Land and Water Conservation Fund Act by any federal agency would be covered into special accounts in the U.S. Treasury and would be available for appropriation to the collecting agency in the year following receipt. Sections of the act that now require these amounts to be deposited in the Land and Water Conservation Fund and that prohibit the imposition of new NPS fees or fee increases would be repealed.

Subtitle D would repeal the permanent appropriation of funds for the Tongass Timber Supply Fund effective October 1, 1987 through September 30, 1989. In place of the permanent appropriation for this time period, subtitle D would authorize the appropriation of at least $40 million annually to maintain the timber supply from the Tongass National Forest.

5. ESTIMATED COST TO THE FEDERAL GOVERNMENT:

The estimated budget impact of these proposals relative to the budget resolution baseline is shown in the following table.

(by fiscal year, in millions of dollars)

	1988	1989	1990	1991	1992
Changes in Direct Spending					
OIL AND GAS RECEIPTS					
Estimated Budget Authority	-10	-20	-20	-20	-20
Estimated Outlays	-10	-20	-20	-20	-20
NATIONAL PARK SERVICE RECEIPTS					
Estimated Budget Authority	-35	-35	-34	-34	-35
Estimated Outlays	-35	-35	-34	-34	-35
RECREATION FEE SPENDING					
Estimated Budget Authority	---	---	---	---	103
Estimated Outlays	---	---	---	---	82
TONGASS TIMBER SUPPLY FUND					
Estimated Budget Authority	-45	-45	0	0	0
Estimated Outlays	-45	-45	0	0	0
Changes in Authorizations					
NUCLEAR WASTE AMENDMENTS					
Estimated Authorization Level	-139	-248	-247	-234	-200
Estimated Outlays	-70	-145	-230	-251	-226

NATIONAL PARK SERVICE COLLECTION COSTS					
Estimated Authorization Level	6	6	5	6	6
Estimated Outlays	5	6	5	6	6
TONGASS TIMBER SUPPLY FUND					
Estimated Authorization Level	45	45	0	0	0
Estimated Outlays	45	45	0	0	0
Total - Direct Spending					
Estimated Budget Authority	-90	-100	-54	-54	48
Estimated Outlays	-90	-100	-54	-54	27
Total - Authorizations					
~~Estimated~~ Authorization Level	-88	-197	-242	-228	-194
Estimated Outlays	-20	-94	-225	-245	-220

The savings from this bill fall within budget functions 270 and 300.

Basis of Estimate:

Subtitle A would change the Nuclear Waste Policy Act and would authorize amounts for appropriation in fiscal years 1988 through 1990. Based on information from DOE, CBO has estimated amounts that would be required in 1991 and 1992 to conduct activities required under the bill. The resolution baseline reflects the requirements of the Nuclear Waste Policy Act of 1982 (including characterization of the three candidate sites and continued study of the need for an MRS facility). The savings shown are the difference between the baseline and the new authorizations (as specified for 1988 to 1990 and estimated for 1991 and 1992). These amounts are still subject to appropriation, and consequently, this proposal does not have a direct spending impact.

The estimated increase in receipts from provisions in Subtitle B depends on a number of very uncertain factors, including the number of acres that would be leased under a competitive system and the amounts of bonus bids that would be received. For the purposes of this estimate, CBO assumed that about 30 percent to 40 percent of the total acreage that would otherwise be leased noncompetitively through the simultaneous oil and gas (SOG) procedures each year would be leased competitively under the terms set forth in the bill. We assumed that the remainder of the acreage would not receive competitive bids and would still be leased noncompetitively. It was assumed that bonus bids would average $15 to $20 per acre.

For purposes of this estimate, CBO has assumed that new fee collections authorized in Title C will begin on the assumed date of enactment (November 15, 1987) and that the Administration will exercise the authority provided to assess new fees and raise existing ones. All recreation fees collected after that date (including those permitted under existing law) would be deposited into the newly created special funds.

Because the agency would be charging fees at new locations (rather than just raising existing fees), additional funding to cover new collection costs, estimated to be $5 million to $6 million, would be needed for each year beginning in fiscal year 1988.

Subtitle C would also amend the Land and Water Conservation Fund Act to permit all recreation fees earned by federal agencies after September 30, 1990 to be available without further appropriation in the year following their deposit into special Treasury funds. Beginning in fiscal year 1992, this provision would create estimated new budget authority of about $103 million. Of this amount, about $68 million would be realized from receipts earned under existing law and $35 million would result from receipts generated by the provisions of the bill.

By repealing the permanent appropriation for the Tongass Timber Supply Fund, Subtitle D would reduce direct spending, both budget authority and outlays, by $45 million in 1988 and 1989. The subtitle also authorizes the appropriation of a minimum of $40 million for those years to support timber management and resource conservation on the Tongass National Forest. Based on information from the Forest Service, we estimate that this authorization would total approximately $45 million annually in 1988 and 1989 in order to meet the production target specified in the bill. If such appropriations are made, this provision would result in no net savings to the government.

More details on the estimates for Subtitles A, B, and C are provided in the previous CBO cost estimates listed below.

6. ESTIMATED COST TO STATE AND LOCAL GOVERNMENTS:

State and local governments would share 50 percent of the additional bonus bid receipts realized from enactment of Subtitle B. CBO estimates that state receipts would consequently increase by approximately $16 billion in fiscal year 1988 and by about $32 million annually thereafter.

7. ESTIMATE COMPARISON: None.

8. PREVIOUS CBO ESTIMATE:

S. 1668 (Subtitle A) was reported by the Senate Committee on Energy and Natural Resources on August 7, 1987. A CBO cost estimate was prepared on September 9, 1987.

October 22, 1987

ESTIMATED RECONCILIATION SAVINGS FROM RECOMMENDATIONS OF THE SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES--RELATIVE TO THE OCTOBER 10 SEQUESTER BASE (In millions of dollars).

	Savings Relative to Sequester Base - FY 1988	
	Budget Authority	Outlays
Oil and Gas Receipts	-10	-10
National Park Service Receipts	-35	-35
Tongrass Timber Supply Fund	-45	-45
TOTAL	-90	-90

The Federal Onshore Oil and Gas Leasing Act (Subtitle B) was ordered reported by the Senate Committee on Energy and Natural Resources on July 29, 1987. CBO prepared a cost estimate for this bill on September 28, 1987.

On June 19, 1987, CBO prepared a cost estimate for H.R. 1320, as ordered reported by the Senate Committee on Energy and Natural Resources, June 19, 1987. CBO's estimate for Subtitle C is identical to that of the June 19 submission, except for the new direct spending of recreation fee collections, which would take effect later in this bill than under H.R. 1320.

9. ESTIMATE PREPARED BY: Kim Cawley, Teri Gullo and Deb Reis (226-2860)

10. ESTIMATE APPROVED BY:

C.G. Nuckols
for James L. Blum
Assistant Director
for Budget Analysis

COMMITTEE ON ENVIRONMENT AND PUBLIC WORKS

Title V

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United States Senate
COMMITTEE ON ENVIRONMENT AND PUBLIC WORKS
WASHINGTON, DC 20510-6175

October 19, 1987

Honorable Lawton Chiles
Chairman
Committee on the Budget
U.S. Senate
Washington, D.C. 20003

Dear Lawton:

Enclosed is legislation reported by the Senate Environment and Public Works Committee to comply with reconciliation instructions under H.Con. Res. 93, the Concurrent Resolution on the Budget for Fiscal Year 1988. The resolution requires the Committee to achieve savings of $150 million in budget authority and outlays in each Fiscal Years 1988, 1989 and 1990.

There are several components to the legislation we are transmitting with this letter. To comply with reconciliation instructions, the Committee has reported legislation authorizing the Environmental Protection Agency to collect $40 million annually in fees in each Fiscal Years 1988, 1989 and 1990. The Committee has also reported reforms to the Nuclear Waste Policy Act which will result in substantial programmatic savings. Included are additional user fees to be collected by the Nuclear Regulatory Commission (NRC) equal to $50 million annually in Fiscal Years 1988, 1989 and 1990 and an increase in contributions to the Nuclear Waste Fund equal to $25 million in those years.

I bring to your attention concerns raised by Committee Members during the reconciliation markup. Specifically, the scoring methods used by the Budget Committee have contributed to confusion in matters of committee jurisdiction and raised some basic questions of fairness. Despite the assumption of increased NRC user fees in the reconciliation instruction to this Committee, as the Committee of jurisdiction, it is our understanding that savings from a similar action have already been credited to the Appropriations Committee.

A second matter of concern is scoring of savings to the Energy and Natural Resources Committee based on amendments it reported to the Nuclear Waste Policy Act as part of reconciliation. The Environment and Public Works Committee has a vested jurisdictional interest in the same issues and Members have concluded that the Committee is well within bounds to report similar legislation and claim estimated savings.

We have submitted this legislation to the Congressional Budget Office for a complete cost estimate. We will submit the cost estimate separately to the Budget Committee when it is available. This legislation, if enacted, will yield greater savings than required by the reconciliation instructions and will result in substantial savings to the Federal government.

Sincerely,

Quentin Burdick
Quentin N. Burdick

Environmental Protection Agency Fees

The Committee is reporting legislation authorizing the Environmental Protection Agency (EPA) to collect $40 million annually in fees in fiscal years 1988-1990. A provision is included to require that fees be deposited in a special fund at the Department of Treasury, for appropriation to the Agency and to the program for which the fee was collected. This legislation is consistent with the President's budget request and draft legislation submitted by the Agency to Congress this year.

The President's budget proposes that $40 million in user fees will be collected for five Agency activities in fiscal year 1988 including: pesticide registration; premanufacture notification for new chemicals under the Toxic Substances Control Act; industrial ocean dispoal permits; mobile source certification; and quality control and quality assurance evaluation services provided to the private sector. Proposed user fee rules have been issued for three of these activities including pesticide registration, quality control evaluation samples, and premanufacture notification.

Last year, an Agency Task Force on fees was created to review user fee options. Based on the Task Force fee report, in addition to the proposals noted previously, the Agency is studying the feasibility of assessing fees for pesticide reregistration; Federally administered activities under the hazardous waste program; and additional quality control and quality assurance evaluation services.

The Committee is supportive of EPA efforts to find additional user fee opportunities under existing authorities and provisions of law. The Water Quality Act of 1987, for example includes a provision requiring EPA to assess fees for processing certain water quality permit applications. However, the Committee directs the Agency to consider only those fees that do not interfere with fee programs established by the States; that do not have a disproportionate effect on particular regions of the country; and that are directly related to the cost to the Agency for the service provided.

The $40 million annual user fee authorization contained in this legislation is in addition to existing authority available to the Agency to collect fees. This level is not a cap on the total amount of fees that the Agency may collect.

COMMITTEE ON FINANCE

Title VI and VI-A

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United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510-6200

October 19, 1987

The Honorable
Lawton Chiles
Chairman
Committee on the Budget
United States Senate
Washington, D. C.

Dear Mr. Chairman:

I hereby submit the statutory language implementing the recommendations of the Committee on Finance for purposes of the reconciliation bill provided for in H. Con. Res. 93, the first concurrent resolution on the budget for fiscal year 1988. Also enclosed are materials which explain these provisions.

These statutory provisions will reduce outlays for programs (other than the Pension Benefit Guaranty Corporation) within the jurisdiction of the Committee on Finance by $1.543 billion in fiscal year 1988 and by $8.773 billion over fiscal years 1988-1990. These provisions will increase the receipts of the Pension Benefit Guaranty Corporation by $0.390 billion in fiscal year 1988 and by $1.440 billion over fiscal years 1988-1990. In addition, the revenue provisions will increase Federal receipts (other than the Pension Benefit Guaranty Corporation) by $11.13 billion in fiscal year 1988 and by $49.91 billion over the three-year period.

Sincerely,

Lloyd Bentsen

LLOYD BENTSEN
Chairman

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SUBTITLE 1—HEALTH, SOCIAL SERVICES, AND INCOME SECURITY

Part A—Provisions With Major Budgetary Impact

SUBPART I—PROVISIONS AFFECTING MEDICARE PART A

HOSPITAL PAYMENTS (Sec. 6001)

(a) Applicable Percentage Increase in Payments for Inpatient Hospital Services

Present Law.—The Omnibus Budget Reconciliation Act of 1986 (OBRA) required the Secretary of Health and Human Services (HHS) to increase the payment rates for prospective payment system (PPS) hospitals and the target amounts for PPS-exempt hospitals for FY 1988 by the market basket increase (currently estimated to be 4.7 percent) minus two percentage points, resulting in an update of 2.7 percent.

Percentage increases for subsequent fiscal years are determined at the Secretary's discretion. For the purposes of projecting future spending, hospital payment rates for FY 1989 and FY 1990 are assumed to be increased by the market basket. The Congressional Budget Office's current estimates for the market basket are 5.0 percent in FY 1989 and 5.2 percent in FY 1990. OBRA also authorized a different payment increase for PPS and PPS-exempt hospitals.

Both the Secretary and the Prospective Payment Assessment Commission were required to report to Congress with their recommendations for an appropriate FY 1988 payment increase. PROPAC has recommended increases of 2.2 percent for urban hospitals, 3.0 percent for rural hospitals and an increase in the target amounts of 4.4 percent for PPS-exempt hospitals. The Secretary has recommended an increase of .75 percent for PPS hospitals and 1.9 percent in the target amounts for PPS-exempt hospitals.

Under P.L. 100-119, payment rates for all hospitals have been frozen—increased by zero percent—for the period October 1-November 20, 1987.

Committee Provision.—In FY 1988, payment rates for urban hospitals will be increased by 1 percent, rural hospitals by 4.2 percent and target amounts for PPS-exempt hospitals by the market basket minus 2 percent, which is currently estimated to be 2.7 percent.

In FY 1989, payment rates for urban and rural hospitals will be increased by the market basket minus 2.0 percent and exempt hospitals' target amounts will be increased by the market basket. In FY 1990, urban and rural payment rates will be increased by the market basket minus 1.6 percent and exempt hospitals' target amounts by the market basket.

After FY 1990, the Secretary has the discretion to determine separate payment increases for urban, rural and PPS-exempt hospitals.

Effective Date.—Payment rates for PPS hospitals will be increased November 21, 1987. Target amounts for PPS-exempt hospitals will be increased on the 52nd day following the beginning of cost reporting periods beginning in FY 1988.

(b) Medicare Payments to Sole Community Hospitals

Present Law.—Sole community hospitals (SCHs) meet eligibility criteria set by the Secretary of HHS. Currently about 365 hospitals have been granted sole community hospital status. However, other hospitals located in isolated rural areas could qualify for SCH designation but have not applied.

Under the Medicare hospital prospective payment system (PPS) SCHs are paid on the basis of a blend of 75 percent of their own hospital specific costs and 25 percent of the applicable federal payment rate. The Secretary is also required to provide appropriate payment adjustments to a sole community hospital that: (1) experiences, during a fiscal year beginning before October 1, 1988, a decline in overall total inpatient admissions of 5 percent or more due to circumstances beyond its control; or (2) add services or facilities that increase its costs significantly over the base year period used to set payment rates. SCHs are exempt from FY 1987–89 capital cost reductions adopted in the Omnibus Budget Reconciliation Act of 1986.

Committee Provision.—The provision requires the Secretary of HHS to issue, within 120 days of enactment, explicit criteria for implementing a volume adjustment to SCHs.

The provision also extends the volume adjustment through FY 1990, and allows hospitals to qualify as SCHs for the purposes of receiving a volume adjustment but to continue receiving the 100 percent Federal PPS payment rate.

Effective Date.—The Secretary's criteria will be issued within 120 days after enactment. The volume adjustment will be available to all qualifying hospitals for cost reporting periods beginning on or after October 1, 1987, and discharges occurring on or after October 1, 1987.

(c) Impact Analyses of Medicare and Medicaid Rules and Regulations on Small Rural Hospitals

Present Law.—The Secretary of Health and Human Services (HHS) is not explicitly required to provide an analysis of the effects on rural hospitals of proposed or final rules and regulations under Medicare and Medicaid.

Committee Provision.—The provision requires the Secretary of HHS to include in any Notice of Proposed Rulemaking under Medicare or Medicaid that may affect a significant number of rural hospitals, a published analysis of the impact of the proposed rule on such hospitals. The Secretary is required to make available a final impact analysis when such rules are promulgated in final form.

Effective Date.—Enactment.

(d) Hospital Cost Report

Present Law.—The Secretary of Health and Human Services (HHS) is required to maintain a system for reporting prospective payment (PPS) hospital costs through September 30, 1988. There are no requirements regarding the maintenance of a data base of hospital costs or the filing of electronic cost of reports.

Committee Provision.—The provision requires the Secretary to develop a data base on the operating costs of inpatient hospital services of a representative sample of hospitals for use in determining annual hospital payment increases and evaluating the effects of legislative, regulatory and budgetary changes. These data will be collected from hospitals with fiscal years beginning during the first four months of the Federal fiscal year and should, to the extent practicable, adequately represent small rural hospitals, sole community hospitals and rural referral centers. The Secretary is required to report to Congress on the development of this data base by October 1, 1988.

The provision also requires the Secretary to develop a data base on the operating costs for inpatient hospital costs for all hospitals by June 1, 1989. This data base will be maintained on a "rolling" basis for the most recent twelve months available, and will be updated at least quarterly. The Committee understands that such a data base will consist of preliminary data, and the provision requires that the Secretary make available analyses of differences between preliminary and settled cost reports. Information from this data base will be released by the Secretary.

For hospital cost reporting periods beginning on or after October 1, 1989, hospitals will be required to submit cost reports using a standardized electronic format. The Secretary has the authority to delay or waive this requirement for small hospitals, rural hospitals, and hospitals with a small percentage of Medicare volume.

The Secretary is required to consult with the hospital industry in implementing this provision.

Effective Date.—Enactment.

(e) PROPAC Report on Study of Separate DRG Rates for Urban and Rural Hospitals

Present Law.—Medicare's prospective payment system (PPS) pays for each hospital discharge a fixed rate, adjusted for certain factors. Separate fixed rates are set for urban and rural hospitals. The Secretary of Health and Human Services is required to report to Congress on the feasibility and impact of eliminating or phasing out separate urban and rural rates.

Committee Provision.—The provision requires the Prospective Paymant Assessment Commission to evaluate the Secretary's report and report its conclusions and recommendations to Congress by March 1, 1988.

Effective Date.—Enactment.

(f) Survey of Wage Costs

Present Law.—Medicare hospital payments are adjusted by a wage index to take into account differences in hospital wage levels in each geographic area compared to the national average hospital wage level. In FY 1988, under regulations published by the Secretary, the wage index adjustment will be based on a blend of 1982 and 1984 data from a survey of hospital wages. The Secretary of Health and Human Services (HHS) is authorized under current law to make periodic adjustments in the wage index, but there is no statutory provision regarding the timing or methods the Secretary must use.

The survey-based wage index does not account for variations in hospital occupational mix and includes data with respect to wage costs of skilled nursing facility services.

Committee Provision.—The Secretary is directed to conduct and update a survey of wages and wage-related costs of Prospective Payment System (PPS) hospitals for the purpose of updating the Area Wage Index applied in determining payments for PPS hospitals on or after October 1, 1989 and every 36 months thereafter.

The survey will, to the extent deemed feasible by the Secretary, measure the earnings and paid hours of employment by occupational category and will exclude data with respect to the wages and wage-related costs incurred in furnishing skilled nursing facility services.

Effective Date.—Enactment.

(g) Revision of Standards for Including a Rural County in an Urban Area

Present Law.—Hospital payment rates for each discharge under Medicare's prospective payment system (PPS) are generally set higher for hospitals located in urban areas than for those that are located in rural areas. The demarcation between the urban and rural classifications is set by the geographical boundaries of various Metropolitan Statistical Areas (MSAs). In general, hospitals located within an MSA receive urban rate reimbursement; those not within the boundaries of an MSA are reimbursed at a rural rate. The Office of Management and Budget has established criteria by which counties bordering on cities may be determined to be a part of an urban area. One of these criteria regards the rate of commuting by residents of the county to employment in the central county of an adjoining MSA.

Only rural counties which meet the commuting criteria for at least one urban area qualify as part of the MSA. Rural counties with the same level of commuting divided among several adjacent urban areas are not considered urban, and hospitals in those counties receive the rural rate.

Committee Provision.—For purposes of Medicare payment, the provision designates as urban those rural counties from which at least 15 percent of workers commute into all adjacent MSAs or at least 20 percent of workers commute in either direction from the central city. In addition, the average wages paid by hospitals in the county must be at least equal to the average wages paid by rural hospitals in the State and must be at least equal to 85 percent of the average wage paid by hospitals in the MSA to which most workers from the rural county commute. For purposes of Medicare payment, such counties will be considered an outlying county of the MSA to which most workers from the rural county commute.

For the purposes of Medicare payments for inpatient hospital services, Watertown Memorial Hospital in Watertown, Wisconsin is deemed to be located in Jefferson County, Wisconsin.

Any cost of this provision will be offset by a reduction in urban hospital payment rates.

Effective Date.—Hospitals in affected counties will be paid as urban hospitals for discharges on or after November 21, 1987.

(h) Clinic Hospital Wage Indices

Present Law.—Hospital payment rates under the Prospective Payment System (PPS) are adjusted to take into account differences in wages from area to area. This is accomplished by means of an area wage index, which is based on hospital wage records for full and part time hospital employees. The index does not reflect the wage costs of outside suppliers or of employees of related organizations.

Committee Provision.—The provision directs the Secretary to include in the area wage index calculation the wages of employees of related organizations who are directly involved in the provision of care to hospital inpatients. The wage costs must be incurred in the hospital's Metropolitan Statistical Area. The provision only applies to institutions described in section 602(k) of the Social Security Amendments of 1983 (P.L. 98-21).

Effective Date.—Applies to payment adjustments for discharges occurring on or after January 1, 1987.

(i) Psychologists' Services Furnished to Hospital Inpatients

Present Law.—Medicare includes within the definition of covered inpatient hospital services "such other diagnostic or therapeutic items or services, furnished to inpatients either by such hospital or by others under such arrangements." The services of psychologists employed by or providing services under arrangements with hospitals have been included under this authority.

Committee Provision.—The provision clarifies in statute that inpatient hospital services for which payment may be made under Part A may include services provided by a clinical psychologist as defined by the Secretary.

Effective Date.—Date of enactment.

(j) Hospital Condition of Participation Relating to Psychologists

Present Law.—Medicare conditions of participation for hospitals require that all patients at the hospital be under the care of a physician. Medicare does not include a psychologist within the definition of physician. Under some State laws, a psychologist may admit a patient to a hospital and treat the patient. The Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) and the Federal Employees Health Benefits Act (FEHBA) allow coverage of services of a psychologist in accordance with State law. However, since the Medicare conditions of participation apply to all patients in the hospital (not just Medicare patients), the Medicare requirement has the effect of negating State law and the CHAMPUS and FEHBA policies for any hospital that participates in Medicare.

Committee Provision.—The Medicare condition of participation is modified so that the requirement that patients be under the care of a physician will apply only to Medicare patients, and State law will control in the case of other patients.

Effective Date.—Date of enactment.

(k) Outlier Payments for Burn Cases

Present Law.—Under the prospective payment system (PPS), Medicare generally pays a hospital a fixed amount per discharge, based on the patient's diagnosis. Outlier payments are additional payments made for cases that exceed the average length of stay (day outliers) or average cost (cost outliers) by a specified multiple or dollar amount. For days that exceed the established threshold, hospitals are paid 60 percent of the per diem rate for that diagnosis, and for costs that exceed the threshold, hospitals are paid 60 percent of the excess costs. If a patient qualifies as both a day outlier and cost outlier, payment is made on the basis of the day outlier.

Committee Provision.—Outlier payments for burn diagnoses will be paid at 90 percent of the average per diem rate or excess cost above the threshold. This provision will apply for two years. The Prospective Payment Assessment Commission shall make a recommendation regarding any modifications to the prospective payment system to better accommodate outliers for burn cases, including a recommendation as to whether there should be separate payment rates for burn center hospitals.

Effective Date.—Discharges after November 20, 1987 and before October 1, 1989.

(l) Changing Cost-Effectiveness Performance Period under Demonstration Project Reimbursement System

Present Law.—Maryland operates a state health cost control system, under which Medicare payments to hospitals are made through a waiver. Maryland's Medicare waiver is continued subject to a performance test which compares the state's rate of increase in Medicare per-admission costs to the national average increase. This comparison is currently made for the previous three-year period.

Committee Provision.—This provision maintains the cost-effectiveness performance test for Maryland's waiver but extends the period over which it applies to a period beginning October 1, 1983 and ending at the end of the most recent period for which data are available.

Effective Date.—Enactment.

(m) Maintaining Method of Reimbursing Hospitals for Bad Debt under Prospective Payment System

Present Law.—Medicare beneficiaries are required to pay a hospital deductible for the first admission in a spell of illness and daily coinsurance for hospital care after the sixtieth day. When beneficiaries do not pay these amounts to the hospital and the hospital has either made a reasonable collection effort or has determined that the patient is indigent, then Medicare pays hospitals for these bad debts. Bad debt payments are "cost pass-throughs" in addition to payments made under the prospective payment system (PPS).

Under P.L. 100-119, the Secretary of HHS is prohibited from eliminating payments for bad debt until November 21, 1987.

Committee Provision.—The Secretary is prohibited from promulgating regulations to alter the current method of reimbursing PPS hospitals for bad debt. The Secretary is required to continue making these payments under policy guidelines in place on March 31, 1987, including criteria for what constitutes a reasonable collection effort.

Effective Date.—Enactment.

(n) Report on Outlier Payments

Present Law.—Medicare pays hospitals an additional amount for extraordinarily long or costly cases, known as "outliers." These additional payments are funded by setting aside a proportion of hospital payments made under the prospective payment system. The Secretary of Health and Human Services is authorized to reduce hospital rates in order to fund outlier payments by computing a proportion "estimated" by the Secretary to equal not less than 5 percent nor more than 6 percent of total prospective payment system payments "projected or estimated" to be made in that year. The 1986 Omnibus Budget Reconciliation Act included a provision that established separate urban and rural set-asides for outlier payments.

Committee Provision.—The Secretary is required to include in an annual report to Congress a comparison of the total reductions and payments for outliers for hospitals in urban and rural areas respectively.

Effective Date.—Enactment.

(o) Classification of Rural Referral Centers

Present Law.—Rural hospitals are treated as rural referral centers under Medicare's prospective payment system if they have over 500 beds or meet certain case-mix, referral or volume criteria. Qualifying hospitals are paid on the basis of urban payment rates.

Committee Provision.—Qualifies rural hospitals with more than 275 beds as rural referral centers.

Effective Date.—November 21, 1987.

(p) Grant Program for Rural Health Care Transition

Present Law.—No provision.

Committee Provision.—The provision creates a grant program and authorizes the appropriation of $15 million annually from the Hospital Insurance Trust Fund for fiscal years 1989 and 1990. Under the program, the Secretary may grant up to $50,000 per year, for up to two years, to certain hospitals that desire to modify the type and extent of the health care services they provide.

Private non-profit or public (non-federal) hospitals in rural areas with less than 100 beds and providing general medical services are eligible to apply for grants. Eligible hospitals will submit applications through the office of the Governor of a State to the Secretary detailing the nature of the proposed project, the data on which the proposal is based, and the timetable for completion.

In reviewing the application, the Secretary shall consider the comments of the Governor, the effect the project will have on reducing Hospital Insurance Trust Fund expenditures and in improving access of Medicare beneficiaries to health care, the applicant's understanding of the health care needs of the community, and the anticipated degree of coordination with local and regional health care providers and with community and government leaders.

Effective Date.—Date of enactment.

(q) Delay in Requirements Relating to Hospital Standards for Organ Transplants and Standards for Organ Procurement Agencies

Present Law.—The Omnibus Budget Reconciliation Act of 1986 required that hospitals that perform organ transplants, and organ procurement agencies, must be members of and abide by the rules of the Organ Procurement and Transplantation Network. The Act also required that the Secretary designate a single organ procurement agency for each service area. These requirements were to become effective October 1, 1987, but were delayed until November 20, 1987 by the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987.

Committee Provision.—The effective date of the requirements is delayed until December 31, 1988.

Effective Date.—November 21, 1987.

MEDICAL EDUCATION (Sec. 6002)

(a) Change to Adjustment for Indirect Medical Education

Present Law.—The Secretary of Health and Human Services (HHS) is required to pay an additional amount for each discharge from a prospective payment system (PPS) hospital which has interns and residents in approved teaching programs, and indirect medical education costs. This amount varies with the hospital's ratio of interns and residents to beds, but is approximately 8.7 percent for each .1 percentage point of the hospital's ratio.

This adjustment is temporarily reduced to approximately 8.1 percent through September 30, 1989. The remaining .6 percent is used to finance additional payments to hospitals serving a disproportionate share of low-income patients, and certain other hospitals that receive a large share of public revenue. Disproportionate share payments are authorized through September 30, 1989.

The Congressional Budget Office has estimated that more recent data imply an indirect medical education adjustment of 6.9 percent rather than 8.7 percent.

Committee Provision.—The Committee provision reduces the indirect medical education adjustment to approximately 6.9 percent. In FY 1988-90, the adjustment is reduced to approximately 6.3 percent which, according to CBO, will maintain financing of disproportionate share payments. (The disproportionate share adjustment is extended through FY 1990 in Section — of this bill.)

Effective Date.—The payment adjustment will be reduced for discharges occuring on or after November 21, 1987.

(b) Rural Health Medical Education Demonstration

Present Law.—Prospective Payment System (PPS) hospitals employing interns and residents receive an additional percentage payment for each Medicare discharge. The amount of the percentage add on is approximately 8.7 percent for every 0.1 percentage point of the hospitals ratio of interns and residents to its number of beds. For the purposes of computing this ratio, interns and residents can only be counted if they are enrolled in an approved teaching program and assigned to the hospital and providing services on September 1.

Medicare also pays hospitals for their direct costs of graduate medical education such as residents and teachers' salaries, administrative costs and classroom expenses. These payments are made separately from and are in addition to the per-discharge DRG payment. The Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA) set rates per resident on approved direct medical education costs.

Committee Provision.—Requires the Secretary to conduct a demonstration project to assist medical residents in developing field clinical experience in rural areas. Under the demonstration, resident physicians would receive from one to three months of training in a rural hospital. For the purposes of the demonstration, the "sponsoring hospital" (the resident's normal assignment) would be allowed to count the resident as though he had not been working at the rural hospital on September 1. Also, the sponsoring hospital would be allowed to exceed the rates for direct medical education by an amount equal to its costs for supervising the residents while at the rural hospital. The rural hospital would receive no increase in medical education payments.

The demonstration would be limited to four projects for three years. Two of the projects would have to be in large rural counties and two in rural counties demonstrating a severe physician shortage. One of each type of project must be east and west of the Mississippi River.

Effective Date.—Enactment.

PAYMENT FOR HOSPITAL CAPITAL-RELATED COSTS (Sec. 6003)

Present Law.—Capital-related costs, including depreciation, interest, rent, and certain other expenses are reimbursed by Medicare on a reasonable cost basis. The Omnibus Budget Reconciliation Act (OBRA) of 1986 directed the Secretary to reduce capital payments to propsective payment system (PPS) hospitals (except sole community hospitals) by 3.5 percent in FY 1987, 7 percent in FY 1988, and 10 percent in FY 1989.

OBRA also prohibited the Secretary of Health and Human Sevices (HHS) from promulgating final regulations altering the method of payment for capital costs under Medicare until September 1, 1987. The Secretary has published final regulations incorporating payments for capital into PPS, effective October 1, 1987. Consistent with OBRA, these regulations would not affect the aggregate level of payments for capital-related costs during FY 1988–89 beyond the mandated percentage reductions, but according to the Congressional Budget Office would save $570 million in FY 1990.

Under P.L. 100-199, implementation of the Secretary's regulations has been delayed until November 21, 1987. During the period October 1-November 20, 1987, payments for capital-related costs will continue to be reduced 3.5 percent (the same reduction as in FY 1987). The seven percent reduction takes effect November 21, 1987.

Current law also prohibits payments under Medicare for capital-related costs of hospital capital expenditures obligated after November 20, 1987 under certain conditions. If the Congress has not enacted legislation regarding payment for capital-related costs of hospital inpatient services before November 21, 1987, no payment can be made for capital costs related to a capital expenditure obligated after November 20, 1987, unless the State has a capital expenditure review agreement with the Secretary under section 1122(b) and the State has recommended approval of the capital expenditure.

Committee Provision.—Capital-related costs (except for sole community hospitals) will be reduced 10 percent for portions of FY 1988 after November 20, 1987 and for the full year in FY 1989–90. The Secretary is prohibited from implementing final regulations altering the method of paying for hospital capital-related costs until October 1, 1989.

The Secretary is also be prohibited from changing the definition of reasonable cost for hospital capital until October 1, 1989.

Effective Date.—November 21, 1987.

ELIMINATION OF PERIODIC INTERIM PAYMENTS (PIP) FOR CERTAIN HOSPITALS AND EXTENSION OF DISPROPORTIONATE SHARE ADJUSTMENT (Sec. 6004)

Present Law.—Under current law, prospective payment system (PPS) hospitals serving a disproportionate share of low-income patients, and certain other hospitals that receive a large share of public revenue, receive an additional payment for each discharge. This adjustment is made through September 30, 1989.

Under periodic interim payments (PIP), Medicare providers can choose to be paid on a bi-weekly basis, with payments set to approximate expected annual reimbursement and without regard to actual bills. Settlement is made at the end of the year. The Omnibus Budget Reconciliation Act of 1986 (OBRA) eliminated PIP for most PPS hospitals, but maintained PIP for hospitals exempt from PPS, skilled nursing facilities, home health agencies, and hospices.

PIP was also preserved for rural hospitals with 100 or fewer beds and disproportionate share hospitals with a payment adjustment of 5.1 percent or more. To continue receiving PIP, these hospitals must have been receiving PIP on June 30, 1987, and must continue to qualify for PIP under regulations in place on October 1, 1986.

Committee Provision.—The provision extends the disproportionate share adjustment through September 30, 1990, on a budget-neutral basis.

The last PIP payment scheduled in FY 1989 will be made in FY 1990. Effective July 1, 1990, PIP will be eliminated for disproportionate share hospitals. The Secretary would be authorized to grant exceptions to continue PIP for hospitals demonstrating an immediate threat to their ability to operate.

Effective Date.—Enactment.

SUBPART II—PROVISIONS AFFECTING MEDICARE—PARTS A AND B

PAYMENT CYCLE STANDARDS (Sec. 6011)

(a) Payment Floor

Present Law.—Fiscal intermediaries who process Medicare Part A payments are required to pay 95 percent of clean claims within an applicable number of days after receipt. The applicable number of days is 26 in FY 1988, 25 for FY 1989, and 24 for FY 1990 and thereafter.

Carriers who process Part B payments are under the same requirements, except that for claims submitted by participating physicans, the standards are 19 days in FY 88, 18 for FY 89, and 17 for FY 90 and thereafter.

If payment is not received on the due date, interest is paid beginning on the day after the due date and ending on the date on which payment is made.

Under P.L. 100-119, the Secretary of HHS is prohibited from taking any action primarily intended to delay the processing of claims until November 21, 1987.

Committee Provision.—In FY 1988, the Secretary must establish a "floor" of ten days from the time of receipt for each Medicare claim. This floor is set at eleven days on FY 1989 and twelve days in FY 1990. The current ceilings on claims processing times are unaffected.

Effective Date.—November 21, 1987.

(b) Prompt Payment for Comprehensive Outpatient Rehabilitation Facilities

Present Law.—The Omnibus Budget Reconciliation Act of 1986 established payment requirements for Medicare claims. Claims that are not paid on time are subject to interest payments. Comprehensive outpatient rehabilitation facilities (CORFs) and rehabilitation agencies provide services that are reimbursed under Part B of Medicare, but they are paid by the Part A fiscal intermediaries. Due to this anomaly, these facilities were not included in the prompt pay requirements under either part.

Committee Provision.—Rehabilitation facilities and agencies are included under the prompt pay requirements.

Effective Date.—Date of enactment.

MEDICARE CONTRACTORS (Sec. 6012)

(a) Medicare Contractor Budget

Present Law.—The Secretary of Health and Human Services enters into agreements with organizations to administer Medicare benefits and process payments. The Secretary allocates among Medicare contractors resources made available to administer the program. There is no requirement that the Secretary's methodology for determining individual contractors' budgets be made public.

Committee Provision.—The Secretary is required to publish in the Federal Register by September 1 before each fiscal year the methodology, standards and data used to determine Medicare contractor budgets.

Effective Date.—Effective for budgets beginning with fiscal year 1989.

(b) Payment Safeguards

Present Law.—The Secretary of Health and Human Services makes funds available to intermediaries and carriers who administer Medicare for audit, review of medical necessity, Medicare secondary payor review, and other payment safeguard activities.

Committee Provision.—For each year FY 1988–90, the Committee appropriates $100 million in payment safeguard funding in addition to funds otherwise made available.

The Committee intends that the Secretary has the flexibility to utilize the funding amounts in whatever manner is determined to be the most cost-effective.

Effective Date.—Enactment.

(c) Prohibition of Denial Quotas

Present Law.—The Secretary of Health and Human Services develops standards and criteria for evaluating the performance of Medicare fiscal intermediaries and carriers. There are no statutory requirements respecting criteria related to denial quotas.

Committee Provision.—In establishing standards and criteria, the Secretary is prohibited from using any specified numerical ratio of the dollars that must be saved through denials under utilization review to the dollars spent.

Effective Date.—Enactment.

SECONDARY PAYER PROVISIONS (Sec. 6013)

(a) Application of Secondary Payer Provisions to Governmental Entities

Present Law.—The Omnibus Budget Reconciliation Act of 1986 required that Medicare would be the secondary payer in the case of disabled Medicare beneficiaries who also had group health insurance through their employer or their spouse's employer. The provision applies to employers who have 100 or more employees. There is ambiguity in the statute whether the provision applies to an employer that is a governmental entity.

Committee Provision.—Clarifies that the secondary payer requirement applies to employers that are governmental entities, but that the tax penalty does not apply to those entities.

Effective Date.—January 1, 1987.

(b) Primary Payer Requirement With Respect to End Stage Renal Disease

Present Law.—Individuals who have end state renal disease (ESRD) are eligible for Medicare, without regard to age or disability status. During the first 12 months of eligibility, Medicare coverage is secondary to any employer-based health plan that the individual may have. Medicare will, however, pay first and then seek recovery from the employer-based plan, if payment under the employer-based plan will not be made as promptly as payment would be made under Medicare.

Medicare is also secondary payer in cases where a beneficiary, other than an ESRD patient, is covered under an employer-based health plan by reason of his or his spouse's current employment. Medicare will pay first, and then seek recovery from the employer-based plan, only if it is not reasonable to expect that the employer-based plan will pay.

Committee Proposal.—Conforms the ESRD secondary payer requirement to the other secondary payer provisions to provide that Medicare will only pay first where it is not reasonable to expect payment from the employer-based plan, without regard to whether payment can be expected to be made as promptly as under Medicare.

Effective Date.—Date of enactment.

SUBPART III—PROVISIONS AFFECTING MEDICARE PART B

PHYSICIAN PAYMENTS (Sec. 6021)

(a) Medicare Economic Index

Present Law.—Medicare generally pays for physician services on the basis of the reasonable charge for the service. The reasonable charge is equal to the lower of the physician's actual charge for the service, the physician's customary charge for the service, or the prevailing charge for the service in the area. The prevailing charge was originally set at the 75th percentile of the customary charges in the area, but since 1973 the annual increase in the prevailing charge has been limited to the annual increase in the Medicare Economic Index (MEI). The MEI measures the changes in the operating expenses and earnings of physicians. The MEI for 1988 is estimated to be 3.6 percent.

Committee Provision.—For 1988 the full MEI of 3.6 percent will apply only to primary services, defined as office visits, home visits, nursing home visits and emergency room visits. For the remainder of services, the MEI will be limited to 1 percent.

Effective Date.—January 1, 1988.

(b) Payment Increase for Services Rendered in Underserved Rural Areas

Present Law.—Medicare payment is generally based on reasonable charges as described in (a). Physicians may choose to accept assignment on a claim, in which case the physician agrees to accept the Medicare reasonable charge as the full charge, and may not bill the patient for any amount above the statutorily prescribed 20 percent coinsurance. If a physician agrees to accept assignment on all claims during a year, he is a Medicare participating physician.

Committee Provision.—For physician services rendered in rural underserved areas, an additional payment of 5 percent will be added to the amount Medicare pays the physician, if the physician accepts assignment on the claim. This additional amount will be determined after the calculation of the reasonable charge and deduction of the coinsurance. Rural underserved areas are defined as areas that are outside of a Metropolitan Statistical Area and are within a Health Manpower Shortage Area (a designation currently in use for placing Health Service Corps physicians).

Effective Date.—Services rendered on or after January 1, 1989.

(c) Setting Customary Charge Level for New Physicians

Present Law.—Since a new physician does not have a charge profile from which to calculate his customary charge, his customary charge is set at the 50th percentile of the customary charges in the area. After the physician has been in practice and develops a charge profile, the customary charge is based on that charge profile. As a result of this methodology, some new physicians are being started with a customary charge that is higher than the charge of some established physicians in the same area.

Committee Provision.—The customary charge level for most new physicians will be set at 80 percent of the prevailing charge level in the area. However, for a new physician in a rural underserved area, the customary charge will continue to be set using the current method.

Effective Date.—Applies to physicians who first furnish services to Medicare beneficiaries after September 30, 1987.

(d) Reduction in Prevailing Charge Level for Overpriced Procedures

Present Law.—Medicare payment for physician services is generally based on the reasonable charge as described in (a). The Omnibus Budget Reconciliation Act of 1986 gave the Secretary of Health and Human Services explicit authority to reduce Medicare payments for specific procedures if the charges were not "inherently reasonable". The Secretary has not exercised this authority. The same Act required a reduction of 10 percent in 1987 and 2 percent in 1988 in the prevailing charge levels for cataract surgery. The Act also required that the actual charge of a nonparticipating physician for cataract surgery, or any procedure reduced under the inherent reasonableness authority, must be reduced to 125 percent of the reduced Medicare reasonable charge. This reduction in actual charges could be made in two annual increments.

Committee Provision.—The prevailing charges for 1988 will be reduced on a sliding scale basis for specific procedures, but no prevailing charge will be reduced to a level below 100 percent of the national average. The specific procedures are cataract extraction with intraocular lens implant, intraocular lens insertion, coronary artery bypass surgery, total hip replacement, suprapubic prostatectomy, transurethral resection of prostate, diagnostic dilatation and curettage, and carpal tunnel release. The reduction will be 0 percent for prevailing charge levels at or below the national average and 10 percent for prevailing charge levels at or above 150 percent of the national average. A reduction of between 0 and 10 percent will apply to prevailing charge levels between 100 and 150 percent of the national average, determined on a straight-line sliding scale.

The committee provision reduces only those prevailing charge levels that exceed the national average because the Committee is concerned that even for these procedures, the prevailing charge level in many areas is within reasonable bounds. The Committee is also concerned that differences in the way physicians bundle services for billing purposes may lead to distortions in the application of across the board types of reductions. The Committee encourages the Secretary of Health and Human Services to develop more uniform billing procedures for use by carriers which use bundled services to the extent feasible.

The Committee also intends that the Secretary use the latest coding in determining the reductions under this provision.

Actual charges of a nonparticipating physician for these procedures will also have to be reduced to 125 percent of the prevailing level in a two-year phasedown.

Effective Date.—January 1, 1988.

(e) Corrections to Maximum Allowable Actual Charge Limits (MAACs)

Present Law.—The Deficit Reduction Act of 1984 froze the amounts that Medicare would recognize as reasonable for physician services, and also froze the actual amounts that physicians could bill over and above the Medicare recognized reasonable charge. This freeze ended for participating physicians on March 31, 1986, and for nonparticipating physicians on December 31, 1986. The Omnibus Budget Reconciliation Act of 1986 replaced the freeze on actual charges with a limit on actual charges for nonparticipating physicians. The limit (the maximum allowable actual charge) is established as follows:

(i) If the physician's actual charge during the base period used for purposes of the freeze is equal to or greater than 115 percent of the prevailing charge, he may increase his actual charge 1 percent per year.

(ii) If the physician's actual charge during the base period used for purposes of the freeze is less than 115 percent of the prevailing charge, he may increase his actual charge up to 115 percent of prevailing, but phased in over a four-year period.

(iii) If a physician did not have charges during the base period, the MAAC is set at the 50th percentile of customary charges.

In the case of group practices, different carriers have used different rules in establishing whether a group MAAC will apply to each member of the practice. Some carriers have required that all charges for the group must be uniform only within specialties, while others have required uniform charges across specialties (e.g., for office visits). Carriers have also applied different rules for medical school/teaching hospital departmental practices. Some have required that each department be treated as a separate entity, while others treat the entire hospital as a single group.

Committee Provision.—(1) If a physician did not have any charges during the base period, but was not a "new" physician (e.g., was in practice but did not happen to perform that service during the base period), he will be allowed to use charges from the 12-month period preceding the base period, or charges to non-Medicare patients, to establish his MAAC.

(2) In the case of group practices—

(A) In the case of a multi-specialty group practice, in order to qualify for a group MAAC the charges must be uniform within each specialty, but do not necessarily have to be uniform across specialties.

(B) In the case of hospital departmental practice plans, each department shall be treated separately for purposes of determining MAACs and participation status.

(f) Date for Applying Civil Penalties for use of Assistants at Cataract Surgery

Present Law.—The Consolidated Omnibus Budget Reconciliation Act of 1985 provided that Medicare would not pay for an assistant at surgery for cataracts unless the peer review organization (PRO) approved the use of the assistant prior to surgery. If a surgeon attempted to bill the beneficiary for an assistant at surgery, civil money penalties could be imposed by the Secretary. Delays in implementation of pre-surgical review by the PROs led to a provision included in the Tax Reform Act of 1986 that allowed payment through December 1, 1986, if the use of an assistant was approved after the surgery. PRO pre-surgery review became effective March 1, 1987.

Committee Provision.—No civil money penalties will apply to cases of billing for an assistant for surgery performed prior to March 1, 1987.

Effective Date.—Retroactive to the date of enactment of the Consolidated Omnibus Budget Reconciliation Act of 1985.

(g) Assistants at Cataract Surgery

Present Law.—Medicare will not pay for an assistant at surgery for cataract surgery unless the peer review organization (PRO) approves the use of an assistant prior to the surgery. The PRO may approve the use of an assistant only if the medical condition of the patient warrants an assistant.

Committee Provision.—The PRO may approve the use of an assistant at cataract surgery if it determined that the assistant is necessary because of the use of a surgical technique of established economic benefit (taking into account the cost of the assistant), which eliminates the need for an anesthesiologist or nurse anesthetist. The use of the assistant for such a surgical technique must also be approved by the local carrier.

In determining whether to approve an assistant under this provision, the PRO must make a determination in each case that the total cost to Medicare, including the use of the assistant, will not exceed the total cost to Medicare that would result without the use of the assistant.

Effective Date.—Date of enactment.

(h) Utilization Screens for Physician Services Provided to Patients in Rehabilitation Hospitals

Present Law.—Medicare carriers use utilization screens to check for possible overutilization of services. The screen is established at a level where services in excess of that level would ordinarily not be necessary. If services are provided in excess of that level, the case is then targeted for further review to insure that the services were medically necessary. Some carriers reportedly routinely deny a claim if the service exceeds the screen level, prior to performing additional medical review. The screen for physician visits to hospital inpatients currently does not distinguish between visits to patients in acute care settings and patients in rehabilitation settings where more frequent visits are generally medically necessary.

Committee Provision.—The Secretary must use a separate screen for physician visits to patients in rehabilitation hospitals and rehabilitation units. In establishing the screen, the Secretary shall consult with physician groups representing rehabilitative medicine.

Effective Date.—Six months after enactment.

(i) Collection of Past-due Amounts Owed by Physicians who Breached Contracts Under the National Health Service Corps Scholarship Program

Present Law.—The National Health Service Corps provides scholarship funds for medical training in exchange for a promise to serve in a medically underserved area for a specified period of time. If the physician breaches this agreement, the scholarship must be repaid.

Committee Provision.—The Secretary is required to reduce Medicare and Medicaid payments to physicians who owe past-due amounts resulting from a breach of such an agreement. The reductions will be made pursuant to a repayment schedule agreed to by the Secretary and the physician until the past-due obligation and any interest are repaid.

Effective Date.—Date of enactment.

(j) Study of Prevailing Charges for Anesthesia Services

Present Law.—Medicare payments for physician services are based on the reasonable charge for the service. The reasonable charge is the lowest of the physician's actual charge for the service, the physician's customary charge for the service, or the prevailing charge in the area for the service. In determining the prevailing charge for anesthesia services, carriers use a conversion factor to multiply base and time units to determine the charge. These conversion factors vary considerably among different carrier areas.

Committee Provision.—The Secretary shall conduct a study of the variations in conversion factors and report to Congress by January 1, 1989. The report shall include recommendations for appropriate adjustments in the conversion factors.

Effective Date.—Date of enactment.

(k) Change Reporting Date for Physician Payment Review Commission

Present Law.—The Physician Payment Review Commission is required by law to submit an annual report to Congress by March 1.

Committee Provision.—The date for submission of the annual report is changed to May 1.

Effective Date.—January 1, 1988.

PAYMENTS TO HOSPITAL OUTPATIENT DEPARTMENTS FOR RADIOLOGY

(Sec. 6022)

Present Law.—Hospital outpatient departments are paid under Medicare the lesser of their costs or charges for radiology services.

Under current regulations, the prevailing charge for radiology procedures performed by a physician in the hospital outpatient department is 40 percent of the prevailing charge for physicians doing the same procedure in the office. (This reflects studies showing that 40 percent of charges are associated with the "professional" component of a radiology service, such as interpretation of the test, and 60 percent are "technical" or overhead.)

Committee Provision.—Aggregate payments to hospital outpatient departments for (excluding capital costs) of radiology (diagnostic and therapeutic radiology, nuclear medicine and CAT scans) will be no more than a limit composed of a blend of the hospital's specific costs and 62 percent of 80 percent of the aggregated prevailing physician charges for the same procedures if they had been done in a physician's office.

The Committee expects that effective with cost reporting periods beginning on or after October 1, 1988, hospitals will aggregate costs (excluding capital costs) for radiology procedures separately on their cost reports, and will keep count of the number of each procedure performed. At the end of the year, the hospital's aggregate costs will be compared to its limit. The hospital will be paid the lesser of its costs or the limit. Capital costs would be unaffected.

In FY 1989 the limit would be composed of 65 percent of actual costs and 35 percent of 62 percent of 801 of physician charges. These 65/35 proportions would be 50 percent/50 percent in FY 1990.

The Committee directs the Secretary to study and report to Congress by July 1, 1988 on whether, based on the most recent data available, 40 percent of prevailing charges is still the best estimate of the professional component of those charges. The Secretary should ensure that where Medicare carriers maintain prevailing charges separately for the professional and technical component, the 62 percent be applied to total prevailing charges.

Effective Date.—Hospital cost reporting periods beginning on or after October 1, 1988.

PART B—PREMIUM (Sec. 6023)

Present Law.—When Medicare was established, the Part B premium was set at an amount that would cover 50 percent of program costs. The Social Security Amendments of 1972 modified this requirement to limit increases in premium amounts to the percentage by which monthly Social Security cash benefits increased in the interval since the last premium increase. Because of this limitation, the portion of program costs covered by the premium declined to 25 percent by 1982. The Tax Equity and Fiscal Responsibility Act of 1982 set the premium at the level necessary to cover 25 percent of program costs through 1986. This provision was extended through 1988 by the Deficit Reduction Act of 1984.

Committee Provision.—The requirement that the Part B premium cover 25 percent of program costs, and the hold harmless provision currently in effect that protects beneficiaries from a net reduction in benefits if the premium increase exceeds the COLA benefit increase, are extended through 1989.

Effective Date.—Applies to premiums for calendar year 1989.

COVERAGE OF MENTAL HEALTH SERVICES (Sec. 6024)

(a) Outpatient Services under Part B

Present Law.—Medicare psychiatric services are effectively limited to $250 annually, with an effective beneficiary copayment of 50 percent. This limit applies to all non-inpatient, non-diagnostic services, items and supplies furnished by a physician in his office of the treatment of a mental, psychoneurotic or personality disorder. The limit does not apply to services provided by other health personnel, including home health services, outpatient hospital services and services furnished in a community mental health center, so long as the services are rendered "incident to" the physician's professional service.

Committee Provision.—The provision raises the annual outpatient limit to $1,100 and continues the effective 50 percent copayment. This limit will apply to services currently defined as subject to the limit except that short visits for the sole purpose of and monitoring of prescription psychopharmacological drugs will not be subject to the limit. The Committee expects that the Secretary will define brief visits as those lasting 15 minutes or less and will monitor potential "unbundling" of services. As under current law, services by auxiliary health personnel will not be subject to the psychiatric limitation, even though the services are furnished in connection with a condition included in the definition of "mental, psychoneurotic and personality disorder." These services, because they are rendered "incident to" the physician's professional service, are not included in the $1,100 limitation.

Effective Date.—January 1, 1988.

(b) Partial Hospitalization

Present Law.—There is no explicit authorization for a partial hospitalization benefit, under which psychiatric patients can be treated in a hospital an on outpatient basis.

However, under current Medicare program guidelines, distinct and organized programs based in hospitals can provide care for less than 24 hours daily. A broad range of services is covered, most delivered "incident to" a physician's service. The services must be reasonable and necessary for the diagnosis or active treatment of the patient's condition and must be expected to improve or maintain the patient's condition so as to avoid hospitalization. There are requirements for periodic recertification of the patient's need for care and for a plan of care. The services must be supervised by a physician, who must see the patient periodically as documented in the medical record.

Committee Provision.—The provision writes into law current guidelines governing partial hospitalization benefits. The Committee intends that this provision codify current practice at no additional cost to Medicare.

Effective Date.—Enactment.

RETURN ON EQUITY PAYMENTS TO HOSPITAL OUTPATIENT DEPARTMENTS (Sec. 6025)

Present Law.—The Secretary of Health and Human Services (HHS) is authorized to pay a return on equity capital to proprietary hospital outpatient departments. The rate of return is equal to the interest rate on obligations issued for purchase by the Part A Trust Fund.

The Secretary has published regulations eliminating return on equity payments for proprietary hospital outpatient departments for cost reporting periods beginning on or after October 1, 1987. Under P.L. 100-119, the Secretary is barred from implementing these regulations before November 21, 1987.

Committee Provision.—This proposal would eliminate the Secretary's authority to pay return on equity to proprietary hospital outpatient departments.

Effective Date.—November 21, 1987.

UPDATING MAXIMUM RATE OF PAYMENT FOR RURAL HEALTH CLINICS (Sec. 6026)

Present Law.—Medicare covers services provided in rural health clinics. The amount of the payment is determined by the Secretary on the basis of a reasonable fee. The current per visit payment limit is $32.10, and has not been changed since 1980.

Committee Provision.—The Secretary must update the payment limit within 120 days, taking into account increases in practice costs since 1980. If the Secretary does not update the limit within the 120 days, the limit will automatically rise to $46 (which represents the amount it would be if it had been indexed since 1980 to increases in health costs). The limit is indexed in future years by an index developed by the Secretary that takes into account economic data and the actual costs of furnishing rural health clinic services.

Effective Date.—120 days after enactment.

MEDICARE COVERAGE OF SERVICES OF A NURSE MIDWIFE (Sec. 6027)

Present Law.—Medicare covers the services of certain non-physician health professionals in certain circumstances, and as "incident to" physician services.

Committee Provision.—Medicare will provide coverage for the services of a certified nurse midwife which she is authorized to perform under State law. Payment is based on a fee schedule established by the Secretary, but may not exceed 75 percent of the reasonable charge which would be allowed for the same service performed by a physician.

Effective Date.—First month that begins more than 60 days after enactment.

PSYCHOLOGISTS' SERVICES PROVIDED IN CLINICS (Sec. 6028)

(a) Coverage of Psychologists' Services Furnished at Rural Health Clinics

Present Law.—Medicare does not make direct payments for psychological services delivered by a non-physician provider except in the case of diagnostic testing services. The services of psychologists employed by or providing services under arrangements with hospitals may be included within the definition of inpatient hospital services. Psychologists' services may also be covered as "incident to" physicians' services provided there is direct personal supervision by a physician, and program payment is made directly to the physician.

Payment may be made under Medicare Part B for rural health clinic services. Included in the definition of rural health clinic services are nurse practitioner and physician assistant services and services and supplies incident to such services. The services of such individuals are covered, whether or not the clinic is under the full-time direction of a physician, if the individual is legally permitted under State law to perform such services and meets training, education, and experience requirements prescribed by the Secretary. Medicare payments may not exceed 80 percent of the reasonable costs for such services.

Committee Provision.—Services of psychologists are included within the definition of covered rural health clinic services even when such services are not provided under the supervision of a physician.

Effective Date.—Date of enactment.

(b) Direct Payment for Psychologists' Services Furnished at a Community Mental Health Center

Present Law.—Medicare does not make direct payments for psychological services delivered by a non-physician provider except in the case of diagnostic testing services. The services of psychologists employed by or providing services under arrangements with hospitals may be included within the definition of inpatient hospital services. Psychologists' services may also be covered as "incident to" physicians' services provided there is direct personal supervision by a physician, and program payment is made directly to the physician.

Committee Provision.—Direct payment is authorized for services furnished by a psychologist in a Community Mental Health Center. Payment is limited to those services which the psychologist is legally authorized to provide pursuant to State law.

Effective Date.—Services furnished on or after January 1, 1988.

PAYMENT FOR THERAPEUTIC SHOES FOR INDIVIDUALS WITH SEVERE DIABETIC FOOT DISEASE (Sec. 6029)

Present Law.—Medicare does not provide coverage or reimbursement for therapeutic footwear required for the treatment of severe diabetic foot disease.

Committee Provision.—Medicare will provide coverage of therapeutic footwear for a beneficiary with severe diabetic foot disease when the physician managing the beneficiary's care certifies the medical need for the therapeutic footwear. Following certification, a podiatrist or other qualified physician is required to prescribe the particular type of footwear necessary, and the footwear must be fitted and furnished by a podiatrist or other qualified individual. To avoid conflicts of interest, the physician who certified the need for the footwear is not allowed to furnish the footwear, unless the physician is the only qualified individual in the area.

Medicare will provide payment for only one pair of footwear a year. Payment for therapeutic footwear is limited to 80 percent of the reasonable charge, up to a limit of $300 for custom molded shoes, $100 for extra-depth shoes and $50 for shoe inserts. These amounts include payment for any expenses for the fitting of such footwear. The limits may be lowered by the Secretary or a carrier if the Secretary finds that shoes and inserts or an appropriate quality are readily available below such limits. The limits are indexed by the same percentage increase allowed for durable medical equipment for future years.

Effective Date.—Therapeutic footwear furnished on or after January 1, 1988.

PAYMENT FOR DURABLE MEDICAL EQUIPMENT (Sec. 6030)

Present Law.—Medicare pays for durable equipment (e.g., wheelchairs, oxygen supplies) used in the home. Payment may be on the basis of rental, lease-purchase, or lump sum payment. If the Secretary determines that purchase is more practical or less costly, he may require that the equipment be purchased. However, rental is allowed where purchase would create an undue financial hardship.

Committee Proposal.—Lease-purchase decisions by carriers are simplified and incentives are provided for use of lease-purchase.

All durable medical equipment is divided into three categories—inexpensive equipment (less than $120), indefinite rental equipment, and all other. Current policy is maintained in regard to inexpensive equipment. Items can be rented or purchased; however, program payments are limited to the purchase price. For indefinite rental, beneficiaries may opt to rent, buy or utilize lease-purchase, but no limits are placed on rental payments. For other durable medical equipment, beneficiaries may opt for purchase or lease-purchase from participating suppliers, and may opt for purchase, lease-purchase or rental from non-participating suppliers. On assigned claims, the purchase price under a lease-purchase arrangement may not exceed the reasonable lump sum purchase price of the equipment plus 3 months rent. On unassigned claims, the Medicare payment may not exceed 80 percent of the reasonable lump sum price.

Effective Date.—Equipment first furnished on or after January 1, 1988.

PAYMENT FOR SERVICES OF PHYSICIAN'S ASSISTANT (Sec. 6031)

Present Law.—The Omnibus Budget Reconciliation Act of 1986 provided for Medicare payment for the services of a physician assistant when provided in a hospital or nursing home, or as an assistant at surgery. Allowable charges are limited to an amount equal to a percentage of the charge that would be allowed if the service was performed by a physician. The percentage is 65 percent for service as an assistant at surgery, 75 percent for services provided in a hospital and 85 percent for services provided in a nursing home.

Committee Provision.—Medicare payment is authorized for services of a physician assistant without regard to the setting where the service is provided. The allowable charge in other settings is 65 percent of the allowable charge for a physician.

Effective Date.—Services furnished on or after January 1, 1988.

PAYMENT FOR AMBULATORY SURGERY AT EYE AND EAR SPECIALTY HOSPITALS (Sec. 6032)

Present Law.—Hospital outpatient services are generally paid for under Medicare on the basis of the hospital's reasonable cost. The Omnibus Budget Reconciliation Act of 1986 provided that for those ambulatory surgical procedures which can also be performed in an ambulatory surgical center (ASC), the payment rate for hospital outpatient departments would be modified. Effective October 1, 1987, the modified rate would be based 75 percent on the hospital's reasonable cost and 25 percent on the rate for ambulatory surgical centers. Effective October 1, 1988, the rate will move to a 50/50 blend of the hospital's reasonable cost and the ASC rate. The current law does not make any distinctions based on hospital specialties.

Committee Provision.—In the case of those hospitals that specialize in eye and ear procedures and receive more than 50 percent of total revenues from eye and ear outpatient procedures, the current 75/25 blended rate is extended, rather than moving to the 50/50 blend on October 1, 1988. The Secretary shall study and report to Congress within one year on modifications to the ambulatory surgery rates that may be appropriate for specialty hospitals.

Effective Date.—October 1, 1988.

SUBPART IV—PROVISIONS AFFECTING PEER REVIEW ORGANIZATIONS

REFORMS OF PEER REVIEW PROGRAM (Sec. 6041)

(a) through (f) General Provisions

Present Law.—Medicare contracts with Utilization and Quality Control Peer Review Organizations (PROs) to review the medical necessity and quality of services provided to Medicare beneficiaries. Contracts are for two-year periods. If an incumbent organization meets certain criteria its contract will be automatically renewed; otherwise the contract will be let out for competitive bidding. The Medicare statute provides that PRO reimbursement for direct and administrative costs for any fiscal year may not be less than the aggregate amount expended in fiscal year 1986, adjusted for inflation. Payments are made directly from the Medicare trust funds and are not subject to appropriations.

Committee Provision.—The PRO program is modified as follows:

(a) The Secretary shall report to Congress in one year on the implementation of due process procedures relating to sanctions against physicians, agreed to in May, 1987 by the Health Care Financing Administration, the American Medical Association, the American Association of Retired Persons and the Inspector General of the Department of Health and Human Services.

(b) PROs are required to provide reasonable notice and an opportunity for discussion for any practitioner or provider prior to denying any claim.

(c) Separate funding levels are established for review of inpatient hospital services and review of other services. The minimum funding level is established at the fiscal year 1988 level, adjusted for inflation and changes in review functions.

(d) Performance criteria for evaluating PRO contracts must be published in the Federal Register; contracts must be adjusted when new duties are added for the PRO; contracts shall be for a period of three years.

(e) The Secretary shall give additional weight in selecting PROs to in-State organizations. In any case where an out-of-State organization holds a contract, when that contract expires the Secretary shall not automatically renew the contract, but rather shall allow competitive bidding on the contract, if an in-State organization wants to compete.

(f) At least 50 percent of all reviews must be conducted on-site; PROs must review access to services as part of any HMO review; PROs must hold educational sessions to inform providers and practitioners of the criteria used in reviewing services; psychiatric and rehabilitation services must be reviewed by appropriate specialists; special problems of delivering services in remote rural areas must be taken into consideration by the PRO in establishing norms for review purposes.

(g) Telecommunications Demonstration Projects

Present Law.—No provision.

Committee Provision.—The Secretary is required to establish no fewer than three or more than five demonstration projects to test the feasibility of requiring instruction and oversight of rural physicians in lieu of imposing sanctions.

Projects should be conducted over a period of no less than three years to ensure that sufficient data is obtained to evaluate the effectiveness of intervention and remediation in lieu of sanctions.

It is the Committee's intention that the Peer Review Organization (PRO) responsible for monitoring quality of care in the state participate in the design and implementation of these demonstrations. The Committee encourages the Secretary to contract with medical schools or tertiary care hospitals with established teaching programs to implement these projects. Funds may be used to reimburse for consultative services provided by a physican associated with the medical school or teaching hospital. However, funds may not be used to purchase telecommunications equipment.

Effective Date.—On enactment.

(h) Provider Representation of Medicare Beneficiaries During Appeals

Present Law.—In the Omnibus Budget Reconciliation Act of 1986, providers were allowed to represent Medicare beneficiaries who are appealing a denial of payment for a service. The amendment addressed section 1869 which applies to most appeals of denials, but does not apply to a denial made by a peer review organization (PRO).

Committee Provision.—Providers will be permited to represent beneficiaries who are appealing denials made by a PRO.

Effective Date.—Date of enactment.

(i) Financial Liability of Medicare Beneficiaries for Services Denied Because of Substandard Care

Present Law.—A provider is prohibited from charging a Medicare beneficiary for services for which payment is denied by the Peer Review Organization because the quality of the service was substandard. Physicians may not bill a Medicare beneficiary on an unassigned basis for services that are determined not to be medically necessary.

Committee Provisions.—(1) Clarifies that providers cannot charge the beneficiary for deductibles or coinsurance when payment is denied because of substandard quality.

(2) Prohibits physicians from billing on an assigned or unassigned basis when payment is denied because of substandard quality.

Effective Date.—Date of enactment.

(j) Patient Liability for Hospital Charges During Appeal of Discharge Notice

Present Law.—If a hospital determines that a Medicare patient ought to be discharged, and the attending physician agrees with the hospital's determination, the hospital may notify the patient of the decision, and the patient may then appeal the decision to the Peer Review Organization (PRO). The PRO must review the case and make a decision within one working day as to whether the discharge is appropriate. The hospital may not charge the beneficiary days in the hospital prior to the day after the PRO makes a decision that the discharge is appropriate.

If a hospital determines that a Medicare patient ought to be discharged, but the attending physician disagrees, the hospital may request the PRO to review the case. The statute is not specific as to whether the patient can be charged for days in the hospital after the initial decision and prior to the PRO decision.

Clarify that in either case the patient cannot be charged for hospital days after the initial decision by the hospital and prior to the decision by the PRO.

Committee Provision.—If the hospital requests the PRO to review a case, the hospital must also notify the patient. This notification to the patient shall be treated in the same way as a discharge notice to the patient for purposes of calculating the days for which the beneficiary may not be charged.

Effective Date.—Date of enactment.

SUBPART V—PROVISIONS AFFECTING MEDICAID

NURSING HOME QUALITY (Sec. 6051)

Present Law.—Regulations of the Secretary of Health and Human Services provide standards for the quality of care provided in Skilled Nursing Facilities (SNFs) and Intermediate Care Facilities (ICFs). Medicare covers 100 days of care in a SNF, but does not cover care in an ICF. Medicaid generally covers both levels of care. A study by the Institute of Medicine in 1986 recommended a number of changes in the standards for quality of care.

Committee Provision (subsections (a)-(f) of the bill).—The provision includes requirements for skilled nursing facilities (SNF) and intermediate care facilities (ICF), excluding ICF's for the mentally retarded (ICF/MR). The requirements for skilled nursing facilities will apply for purposes of both Medicare and Medicaid. The provision maintains the separate categories of skilled and intermediate care facilities, but applies many of the skilled facility requirements to intermediate care facilities. The Committee provision includes:

> *Staffing requirements.*—Both SNFs and ICFs are required to provide 24-hour nursing service that is sufficient to meet the nursing needs of the facility, with at least one registered professional nurse employed full time. The Secretary may grant a waiver of this requirement for a facility that is unable to recruit the necessary nursing personnel despite efforts to hire such personnel at the wage level prevailing in the community. For ICFs, this requirement is phased in; facilities having more than 120 beds must meet the requirement by October 1, 1988; facilities having more than 60 beds must meet the requirement by October 1, 1990; and facilities having 60 beds or fewer beds must meet the requirement by October 1, 1992.
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> Facilities having more than 120 beds must also have at least one full-time social worker with at least a bachelor's degree in social work. A facility may meet this requirement by employing an individual with either a bachelor's or master's degree in social work. The Committee makes this change with the intent that the Secretary ensure that requirements regarding consultation and supervision of social work services be at least as

stringent as those in effect prior to enactment of these changes.

The Committee also intends that the Secretary will continue to establish requirements for activity programs and the qualifications of activity professionals. It is the intent of this legislation to maintain the activity program as a condition of participation.

Nurse aide training.—The Secretary, within one year after enactment, must establish minimum standards for programs that train and test nurse's aides, and establish minimum standards for the mechanism by which a State recognizes and approves these programs. These standards must specify the minimum amount of time required for initial and ongoing training. The standard for initial training must be at least 100 hours. The States must specify the programs that meet the minimum requirements established by the Secretary, and must maintain a registry of all individuals who have successfully completed an approved program.

Facilities are required to provide training for individuals hired as nurse aides under a program that is approved by the State. This applies to individuals hired on or after the date that is one year after enactment. Facilities may not employ any individual as a nurse aide for more than 3 months unless the individual has successfully completed an approved training program, and individuals hired before the date that is one year after enactment of the bill must complete an approved testing program within 3 years of date of enactment. Facilities may not allow nurse aides to provide patient care for which the aide has not demonstrated competency.

Resident assessments.—Facilities must perform accurate assessments of each resident, including a preliminary assessment of each resident within 48 hours of admission, and comprehensive assessment within 30 days of admission and at least annually thereafter and whenever there is a significant change in the resident's mental or physical condition. The assessment must include the identification of medical problems and the assessment of physical, mental, and psychosocial functioning and be coordinated by a registered professional nurse and carried out in consultation with appropriate health care providers.

Payment rates.—State Medicaid payment rates for SNF and ICF care must take into account the costs of complying with various quality of care requirements of the bill. Current law requires that the State Medicaid rates for SNF and ICF services must be "reasonable and adequate to meet the costs which must be incurred by efficiently and economically operated facilities in order to provide care and services in conformity with applicable State and Federal laws, regulations and quality and safety standards." Current law also requires that the State must "make assurances satisfactory to the Secretary" that its rates meet this requirement. The Committee realizes that the requirements of this provision of the bill will result in additional costs for many facilities, and the Committee intends that the Secretary strictly enforce the requirements of current law that the State rates must be adequate to allow facilities to meet these additional quality standards.

Survey and certification.—States are responsible for certifying the compliance of SNFs and ICFs (other than facilities of the State) with participation requirements, and the Secretary is responsible for certifying compliance of State-owned facilties. Each facility is subject to an unannounced standard survey not earlier than 9 months, and not later than 15 months, after the date of the previous survey. The frequency of a standard survey will be based on the degree to which a facility was found in the most recently conducted survey to be in compliance with requirements. A survey may be conducted upon any change in ownership of a facility. The Statewide average interval between standard surveys may not exceed 12 months. The standard survey must include an audit of a sample of residents' assessments.

Each facility found to have performed poorly will be subject to an extended survey, and any other facility will be subject to an extended survey at the Secretary's or the State's discretion.

Standard and extended surveys shall be based upon a protocol developed, tested, and validated by the Secretary by October 1, 1988, and certification surveys must be conducted by a multidisciplinary team of professionals (including a registered professional nurse and others selected in accordance with regulations of the Secretary).

Each State must maintain and utilize a specialized survey team for identifying, surveying, gathering, and preserving evidence, and carrying out appropriate enforcement actions against chronically substandard facilities.

The Secretary must conduct sample onsite surveys of a sufficient number of facilities in each State to allow inferences about the adequacy of each State's surveys. If the results of the Secretary's survey differ from the State's, then the Secretary's results will be conclusive for purposes of a determination about compliance with certification requirements.

Enforcement.—The Secretary must develop and implement a range of intermediate sanctions to apply to facilities with deficiencies that do not immediately jeopardize the health and safety of residents, including directed plans of correction, the appointment of receivers, and one or more of the following: civil fines; on-site monitoring by an agency responsible for conducting certification surveys (with the costs of this monitoring paid by the facility without reimbursement; withholding or reducing amounts otherwise payable to a facility; and any other sanction designated by the Secretary.

If the Secretary determines (1) that a SNF has chronically failed to meet substantially the requirements for certification, or (2) determines that the facility's deficiences immediately jeopardize the health and safety of residents, then the Secretary must give public notice of this determination, and may also appoint a receiver for the facility, if it is not already in a period of State-ordered receivership.

States have similar authority to impose intermediate sanctions against SNFs and ICFs participating in Medicaid.

Screening for mentally ill and mentally retarded.—States must have a preadmission screening program for the mentally ill and mentally retarded to determine the need for nursing facility care. States must also review and determine for each mentally ill and mentally retarded resident of a nursing facility (1) whether the individual requires the level of services provided by a nursing facility or whether the individual requires the level of services provided by another institution, and (2) whether the individual requires active treatment.

National Commission.—A National Commission on Long Term Care is created to advise Congress with respect to long-term care issues. The Commission is also required to investigate compliance with Federal Medicaid requirements in any State that has low reimbursement rates for nursing home care and that has in effect a moratorium on nursing home beds.

(g) ICF/MR Plans of Correction or Reduction

Present Law.—The Consolidated Omnibus Budget Reconciliation Act of 1985 provided that if the Secretary determined there were deficiencies with an intermediate care facility for the mentally retarded (ICF/MR), the facility could submit a plan to correct the deficiencies within 6 months, or submit a reduction plan for closing all or part of the facility within 36 months in order to eliminate any physical plant or staffing deficiencies. The Secretary was required to promulgate proposed implementing regulations within 60 days after enactment (April 7, 1986). Proposed regulations were promulgated on July 25, 1986, but final regulations have not been promulgated.

Committee Provision.—The Secretary must publish final regulations within 30 days after enactment, and the effective date of such regulations must be retroactive to the date of enactment of the Consolidated Omnibus Budget Reconciliation Act of 1985.

Effective Date.—Date of enactment.

PROTECTION OF INCOME AND RESOURCES OF COUPLE FOR MAINTENANCE OF COMMUNITY SPOUSE (Sec. 6052)

Present Law.—When one spouse is in a nursing home, after 30 days the couple is treated as separate economic units for purposes of determining Medicaid eligibility. If all or most of the couple's income and resources are in the name of the institutionalized spouse, that spouse must spend down those resources and income to offset the nursing home costs. States provide that an allowance must be set aside for the spouse in the community, but this amount may be as low as the SSI payment level for an individual (currently $340 per month), and lower in 209(b) States.

Committee Provision.—(1) The State must provide a minimum income allowance for the community spouse of $750 per month, plus an excess shelter allowance if shelter costs exceed 30 percent of the income allowance. The combined total of the income allowance and the excess shelter allowance is capped at $1200. These amounts would be indexed in future years to the CPA.

(2) States must allow the community spouse to retain one-half of the couple's assets or $12,000, whichever is greater. However, if one-half of the couple's assets exceeds $48,000, the community

spouse must contribute the excess over $48,000 to the institutionalized spouse. An exception is allowed for income-producing assets to the extent that income from the asset is needed to maintain the community spouse at the minimum income allowance described in (1).

(3) States are required to delay eligibility for Medicaid for individuals in nursing homes who disposed of assets at less than fair market value within the prior 2 years for the purpose of establishing Medicaid eligibility. The length of the exclusion is determined based on the value of the assets and the cost of nursing home care. Any disposal of assets for less than fair market value is presumed to be for the purpose of establishing eligibility unless the individual furnishes convincing evidence that the transaction was exclusively for some other purpose.

Effective Date.—July 1, 1988, with a delay for States that require legislaton to amend the State Medicaid plan.

MEDICAID BENEFITS FOR POOR CHILDREN AND PREGNANT WOMEN

(Sec. 6053)

(a) Through (e) General Provisions

Present Law.—States are required to provide Medicaid coverage to all recipients of Aid to Families with Dependent Children (AFDC), all pregnant women who meet the AFDC income and resource standards, and all children born after October 1, 1983 who are under age five and meet the AFDC income and resources standards. States have the option to cover additional groups with incomes up to 133 percent of the AFDC income level who would otherwise meet the AFDC requirements (medically needy), reasonable categories of children up to age 21 who do not meet the AFDC definition of a dependent child, and children up to age 5 who meet the AFDC income and resource standards. The Omnibus Budget Reconciliation Act of 1986 added an option for States to cover pregnant women, and children under age 1, whose income does not exceed the Federal poverty level. States could expand this coverage to children up to age 5, in one-year increments. States have the option of applying the SSI or AFDC resource limit, or of not applying any resource limit.

Committee Provision.—The provisions added by the Omnibus Budget Reconciliation Act of 1986 are expanded to allow States to cover pregnant women and children with incomes up to 185 percent of the poverty level, to allow accelerated coverage of children up to age 5, and to allow coverage of children up to age 8. The requirement that States must cover children born after October 1, 1983 who are under age 5 is expanded to require coverage up to age 8, phased in over 3 years.

States are given the option of charging a premium for those women and children covered under this provision whose family incomes are between 100 percent and 185 percent of the poverty level. The premium may not exceed 5 percent of the amount by which the family income exceeds the poverty level. States may not require prepayment of the premium, and eligibility may not be terminated for failure to pay the premium until 60 days after the payment was due. The State may waive the premium in cases of undue hardship. State or local funds available under other programs may be used to pay the premiums, and these payments do not count as income to the recipient.

Effective Date.—July 1, 1988.

(f) Certification of Medicaid Eligibility for Newborn Infants

Present Law.—Medicaid eligibility is automatic for one year for babies born to Medicaid recipients, so long as the mother remains eligible. All women who are eligible for Medicaid during pregnancy remain eligible for at least 60 days after the birth, so the child is automatically eligible for at least 60 days. A problem has occurred in some States because children have not been issued a separate eligibility number or card, and providers have denied services because the child's eligibility could not be documented.

Committee Provision.—States are required to allow a child to receive services during the period of automatic eligibility using the eligibility number or card of its mother until such time as the State issues a separate eligibility number or card for the child.

Effective Date.—Date of enactment.

(g) Study and Report on Medical Expenses of Families With Children With Special Health Care Needs

Present Law.—No provision.

Committee Provision.—The Committee recognizes the burdens that extraordinarily high medical costs can place upon individual Americans and their families. During this session of Congress, the Committee acted to increase protection against catastrophic medical costs for the over-65 population. It is the Committee's intention to move forward next year to address high costs of health care of children with chronic illnesses or disabilities.

Because there are significant gaps in information regarding the nation's most seriously ill children, the Committee requests that the General Accounting Office study and report to the Congress no later than February 1, 1988 on the incidence of children with very high medical expenses and the adequacy of their insurance coverage. In addition, the Committee requests that the Office of Technology Assessment (OTA) extend the scope of its previous study on technology-dependent children to include children who have chronic illnesses or disabilities which result in their being developmentally delayed or in their inability to perform one or more normal childhood activities. OTA shall report on the medical expenses, health insurance coverage, and health care needs of these children no later than August 1, 1988.

Effective Date.—Enactment.

MEDICAID PAYMENTS TO PUERTO RICO AND TERRITORIES (Sec. 6054)

Present Law.—The amount of Federal matching payments for Medicaid expenditures by Puerto Rico, the Virgin Islands, Guam, American Samoa, and the Northern Mariana Islands are subject to an annual cap. The current caps are: $63.4 million for Puerto Rico, $2.1 million for the Virgin Islands, $2 million for Guam, $1.15 million for American Samoa, and $550,000 for the Northern Mariana Islands. These caps were last increased in 1984.

The Secretary has authority to waive most Federal Medicaid requirements for the program in American Samoa because of the special circumstances under which health care is provided in American Samoa.

Committee Provision.—The cap for Puerto Rico is raised by $10 million to $73.4 million. The caps for the territories are raised by an equal percentage (approximately 16 percent) to $2.43 million for the Virgin Islands, $2.32 million for Guam, $1.33 million for American Samoa, and $636,700 for the Northern Mariana Islands.

The authority of the Secretary to waive most of the Federal Medicaid requirements for American Samoa is made applicable to the Northern Mariana Islands.

Effective Date.—Applies to fiscal year 1988 and fiscal years thereafter.

FEDERAL REVIEW OF STATE INSPECTION OF CARE DETERMINATIONS

(Sec. 6055)

Present Law.—States are required to have an effective program of medical review of the care of Medicaid patients in skilled nursing facilities, intermediate care facilities and institutions for mental diseases. The reviews are to determine: (1) the adequacy of the services available; (2) the necessity and desirability of continued institutionalization; and (3) the feasibility of meeting health care needs through alternative institutional or noninstitutional services. The State must make a quarterly showing satisfactory to the Secretary that it has in place an effective program of medical review. The Secretary reviews these showings and also conducts onsite surveys to validate the State's quarterly showings. Penalties apply if the State survey fails to review any patient.

Committee Provision.—(1) Permits a substantive Federal re-review which could include an assessment of: (1) the appropriateness of the State's determination of level of care requirements; (2) the adequacy of the services provided; and (3) the State's efforts in communicating deficiencies to the facility and assuring corrective action. State failure to perform effective medical review will subject the State to a disallowance of Federal financial participation (FFP) for those patients covered by the review. The Secretary may also project such findings to the universe of patients where sampling techniques were used.

(2) Modifies the penalty provisions to provide that failure to review any patient's care will not require a penalty, so long as the number of patients who were not reviewed does not exceed the lesser of 2 percent of all Medicaid patients, or 10 patients (or 1 patient in the case of an institution with 50 or fewer Medicaid patients).

(3) Requires States to have a corrective action plan for each facility that addresses deficiencies noted in the inspections. The requirement applies to deficiencies in the services provided to individual patients as well as deficiencies of the facility as a whole.

Effective Date.—January 1, 1988.

PROVISION OF FAMILY PLANNING SERVICES TO INDIVIDUALS ENROLLED IN HMO (Sec. 6056)

Present Law.—Medicaid recipients generally have the freedom to choose their health providers, as long as the provider meets Medicaid requirements. Some Medicaid recipients voluntarily enroll in health maintenance organizations or similar arrangements which limit the providers from whom the recipient may receive services. Family planning services are a required service under Medicaid, but some providers do not provide these services for religious or other reasons.

Committee Provision.—A Medicaid recipient may receive family planning services under the State plan from any qualified provider, even if they are enrolled in a health maintenance organization or similar arrangement.

Effective Date.—Date of enactment.

OPTIONAL MEDICAID COVERAGE OF INDIVIDUALS IN CERTAIN STATES RECEIVING ONLY OPTIONAL STATE SUPPLEMENTARY PAYMENT (Sec. 6057)

Present Law.—Medicaid regulations do not allow States to provide Medicaid coverage to individuals who receive State supplementary payments only (and not SSI payments) unless the State determines eligibility for those payments using the same deductions from income as the SSI program. Some States do not employ the same deduction of the first $20 in income as is provided under SSI, and their State supplementary programs have been called into question by the Health Care Financing Administration.

Committee Provision.—States that do not contract with the Secretary to make their Medicaid eligibility determinations will be permitted to provide Medicaid coverage to their recipients of State supplementary payments without having to use the SSI income deductions.

Effective Date.—Date of enactment.

SUBPART VI—PROVISIONS RELATING TO SOCIAL SERVICES AND INCOME SECURITY

INCREASE IN FUNDING FOR TITLE XX; EXTENSION OF TITLE XX AND CHILD WELFARE SERVICES TO AMERICAN SAMOA (Sec. 6061)

Present Law.—The Title XX social services block grant program provides entitlement funds to the States to provide services aimed at the following five goals: (1) achieving or maintaining economic self-support to prevent, reduce or eliminate dependency; (2) achieving or maintaining self-sufficiency, including reduction or prevention of dependency; (3) preventing or remedying neglect, abuse, or exploitation of children and adults unable to protect their own interests, or preserving, rehabilitating or reuniting families; (4) preventing or reducing inappropiate institutional care by providing for community-based care, home-based care, or other forms of less intensive care; and (5) securing referral or admission for institutional care when other forms of care are not appropriate, or providing services to individuals in institutions.

States are free to determine which services they wish to provide in meeting one or all of these goals. All States and jurisdictions, with the exception of American Samoa, are eligible for funds for social services.

Title XX funds are allocated to the States on the basis of population. There has been a cap on the amount of entitlement funds available to the States, set at 2.7 billion, since 1984.

Committee Provision.—The Committee bill increases the title XX program entitlement cap by $100 million to $2.8 billion for fiscal year 1988. The cap will revert to $2.7 billion in 1989. In addition, American Samoa is made eligible to participate in both the Title XX and the Child Welfare Services programs on a permanent basis.

Effective Date.—October 1, 1987.

EXTENSION OF AUTHORITY TO TRANSFER FOSTER CARE FUNDS (Sec. 6062)

Present Law.—Federal rules for funding State foster care and child welfare services programs are designed to encourage States to provide specific child welfare services as a way of preventing inappropriate or unnecessary placement of children in foster care. In any year that the Federal appropriation exceeds a specified statutory level, there is a mandatory ceiling on the amount of funds that a State is eligible to receive to provide foster care maintenance payments. When this mandatory ceiling is in effect, the State may, under certain circumstances, transfer all unused foster care maintenance funds to its child welfare services program. In any year that the Federal appropriation is below the specified statutory level, the State may choose to operate under a voluntary ceiling. When this voluntary ceiling is in effect, the State may, under certain circumstances, transfer part (not all) of unused foster care maintenance funds to the child welfare services program. The mandatory ceiling was in effect in fiscal year 1981. States have been able to use the voluntary ceiling transfer authority in every subsequent year. The provisions establishing the ceiling and the authority to transfer funds expired September 30, 1987.

Committee Provision.—The provisions establishing the mandatory and voluntary ceilings and the authority to transfer funds are extended for two years, through September 30, 1989. These provsions have given the States the incentive to improve their child welfare services program, and to reduce the number of children in foster care by making more appropirate long-term arrangements for them.

Effective Date.—October 1, 1987.

EXTENSION OF AUTHORITY FOR VOLUNTARY FOSTER CARE PLACEMENTS (Sec. 6063)

Present Law.—Title IV-E of the Social Security Act authorizes Federal matching for payments made by States with respect to AFDC-eligible children placed in foster care homes or institutions. Most placements are made under court order. However, since 1981 there has been temporary authority in the law allowing States to make payments on behalf of children placed in foster care on a voluntary basis. In order to use this authority, States must have in place certain foster care protections and procedures. This authority expired September 30, 1987.

Committee Provision.—The authority to make voluntary placements is extended permanently.

Effective Date.—October 1, 1987.

MOTHER/INFANT FOSTER CARE (Sec. 6064)

Present Law.—If a minor who is placed in foster care has a child, the minor continues to be eligible for foster care payments, but the child is eligible only for regular AFDC benefits, which are generally lower.

Committee Provision.—In cases where a child placed in a foster family home or child care institution is the parent of a son or daughter who is in the same home or institution, the payments made with respect to the child shall also include amounts necessary to cover costs of items provided on behalf of the son or daughter.

Effective Date.—October 1, 1987.

INCREASE IN PERSONAL NEEDS ALLOWANCE FOR SSI RECIPIENTS (Sec. 6065)

Present Law.—The amount payable to a recipient of Supplemental Security Income (SSI) for any month throughout all of which he is in a Medicaid institution is reduced to $25 for an individual, and $50 for an individual and spouse. These amounts are intended to cover the cost of personal needs, such as toiletries and other small items, that are not covered by Medicaid. The present personnel needs allowance amounts have been in effect since the SSI program began in 1974.

Committee Provision.—The Committee agreed to increase the personal needs allowance to $30 for an individual, and $60 for a couple. States will be required to pass through this increase in the Federal payment to recipients.

Effective Date.—January 1, 1988.

INCREASE IN SSI EMERGENCY ADVANCE PAYMENTS (Sec. 6066)

Present Law.—The Social Security Administration may make emergency advance payments of up to $100 to individuals who are presumptively eligible for SSI and who are facing a financial emergency. This amount has not been increased since the program began in 1974.

Committee Provision.—The amount of the allowable emergency advance payment is increased to equal the maximum amount of the regular SSI monthly benefit rate (currently $340 for an individual), plus, if any, the Federally-administered State supplementary payment.

Effective Date.—The first day of the second calendar quarter beginning after the date of enactment.

TRANSFER OF ASSETS FOR LESS THAN FAIR MARKET VALUE (Sec. 6067)

Present Law.—When an individual gives away or sells an asset at less than fair market value, the value of that asset is counted for 24 months after disposal in determining whether the individual meets the SSI resource requirements, if it is determined that the transaction was for the purpose of establishing eligibility for SSI. The transaction is presumed to have been for the purpose of establishing eligibility for SSI, unless the individual furnishes convincing evidence that the transaction was exclusively for some other purpose.

Committee Provision.—The Secretary is required to issue regulations for suspending the transfer of assets rule in cases where he determines that the suspension is necessary to avoid undue hardship.

Effective Date.—The first day of the second calendar quarter beginning after the date of enactment.

TREATMENT OF AFDC BENEFITS UNDER SSI RETROSPECTIVE ACCOUNTING (Sec. 6068)

Present Law.—When an Aid to Families with Dependent Children (AFCD) recipient becomes eligible for SSI, his eligibility for AFCD is terminated. However, rules for determining the amount of an individual's SSI benefit require that the AFCD payment received in a month of application must be counted as income in determining SSI benefits for the first and second months after the month of application. This results in reduced SSI payments for those months, even though the individual's AFCD payments have actually been terminated.

Committee Provision.—AFCD payments made by a State welfare agency must be disregarded in determining SSI benefits.

Effective Date.—The first day of the second calendar quarter beginning after the date of enactment.

EXCLUSION OF REAL PROPERTY WHEN IT CANNOT BE SOLD (Sec. 6069)

Present Law.—An individual may receive SSI benefits for a limited time even though he has property which, if counted, would make him ineligible. These benefits are conditioned upon the disposal of the property, and are subject to recovery as overpayments when the property is sold, or if the individual fails to dispose of them within the required time.

Committee Provision.—The Committee agreed to exclude (and not require the sale of) any real property for so long as it cannot be sold because (1) it is jointly owned (and its sale would cause undue hardship due to loss of housing for the other owner or owners), (2) its sale is barred by a legal impediment, or (3) as determined by regulations issued by the Secretary, the owner's reasonable efforts to sell it have been unsuccessful.

Effective Date.—The first day of the second calendar quarter to begin after the date of enactment.

EXCLUSION OF INTEREST ON BURIAL ACCOUNTS (Sec. 6070)

Present Law.—In determining whether an individual's resources are within the SSI eligibility requirements, there is excluded an amount of up to $1,500 that is placed in a separately identifiable burial account, if the inclusion of any portion of the amount in the account would cause the individual's resources to exceed the SSI resource limits. Any interest earned on the excluded account also is excluded. If the individual's resources are so low that the amount in the burial account would not cause ineligibility, any interest earned is not excluded.

Committee Provision.—In determining whether an individual meets the SSI resource requirements, any interest on designated burial accounts must be excluded, regardless of the amount of the individual's other resources.

Effective Date.—The first day of the second calendar quarter to begin after the date of enactment.

PERMANENT EXTENSION OF AUTHORITY TO DISREGARD IN-KIND ASSISTANCE (Sec. 6071)

Present Law.—In counting income for purposes of determining SSI benefits, the law provides for excluding any support or maintenance assistance furnished to or on behalf of an individual which is based on need for such support or maintenance, including assistance received to help in meeting the costs of home energy (both heating and cooling), and which is: (a) assistance furnished in-kind by a private nonprofit agency; or (b) assistance furnished by a supplier of home heating oil or gas, or by an entity providing home energy. At the option of the State, this kind of assistance may also be excluded in determining AFDC benefits. This provision expired September 30, 1987.

Committee Provision.—The Committee bill makes these provisions a permanent part of the law.

Effective Date.—Effective As if included in the enactment of the Deficit Reduction Act of 1984.

EXCLUSION OF DEATH BENEFITS SPENT ON LAST ILLNESS AND BURIAL (Sec. 6072)

Present Law.—The SSI statute specifies certain kinds of income that must be excluded in determining whether an individual's income meets the SSI income limitations. These include proceeds of a life insurance policy to the extent they are used for purposes of the insured individual's last illness and burial, or $1500, whichever is less.

Committee Provision.—The present law exclusion is expanded to provide for the exclusion of any payments occasioned by the death of another person, to the extent that the payments do not exceed the amount expended for purposes of the deceased person's last illness and burial. Gifts and inheritance must also be excluded to the extent they are used to pay for a last illness or burial. This will allow a surviving spouse to use payments occasioned by the other spouse's death to meet the costs of illness or burial, without having them counted as income for purposes of determining the amount of the SSI monthly benefit.

Effective Date.—The first day of the second calendar quarter to begin after the date of enactment.

FULL BENEFITS FOR SSI RECIPIENTS TEMPORARILY IN INSTITUTIONS (Sec. 6073)

Present Law.—An SSI recipient's benefit is reduced to $25 for any month during all of which he is in a Medicaid institution. Individuals who are in public institutions that are not Medicaid institutions (public mental institutions, for example) are generally not eligible for SSI benefits. Individuals who must enter these institutions for a temporary period often find it difficult to maintain their homes because of the loss of full SSI benefits.

Committee Provision.—Full SSI benefits, including any State supplementary payments, are provided to individuals in public institutions (the primary purpose of which is the provision of medical or psychiatric care) and Medicaid institutions if it is determined that the individual's stay is not likely to exceed three months, and the individual must continue to maintain a home to which he may return upon leaving the institution. A physician's certification that the individual's stay in the institution is not likely to exceed three months must be provided. The Secretary is required to establish procedures for making necessary determinations, and is authorized to enter into agreements with State and local public and private agencies for making such determinations. The procedures and agreements shall include the provision of appropriate assistance to individuals who, because of their physical or mental condition, are limited in their ability to furnish the information needed to make the determinations.

Effective Date.—July 1, 1988.

TREATMENT OF CERTAIN COUPLES IN INSTITUTIONS (Sec. 6074)

Present Law.—States are allowed to treat a husband and wife who have shared a room in a Medicaid institution for a period of six months as a couple (rather than as two eligible individuals, as would otherwise be required under SSI rules) if doing so would prevent a reduction or termination of Medicaid benefits.

Committee Provision.—This provision is expanded to cover situations in which the husband and wife live in the same facility.

Effective Date.—Upon enactment.

SSI ELIGIBILITY FOR INDIVIDUALS IN PUBLIC EMERGENCY SHELTERS (Sec. 6075)

Present Law.—Individuals in a public institution are generally not eligible for SSI. However, SSI benefits are paid for a period of up to three months out of a 12-month period to an otherwise eligible individual who is living in a public emergency shelter for the homeless.

Committee Provision.—Individuals in public emergency shelters for the homeless may receive SSI benefits for up to 6 months out of a 9-month period. In making this change, the Committee wishes to clarify that the term "public emergency shelter for the homeless" means a public institution, or that part of a public institution, used as an emergency shelter by the Federal government, a State, or a political subdivision of a State, primarily for making available on a temporary basis a place to sleep, food, and some services or treatment to homeless individuals. A medical facility (as defined in regulations) or any holding facility, detoxification center, foster care facility, or the like that has custody of the individual is not a public emergency shelter for the homeless. Similarly, transitional living arrangements such as a halfway house that are part of an institution's plan to facilitate the individual's adjustment to community living are not public emergency shelters for the homeless.

Effective Date.—The first day of the second calendar quarter beginning after the date of enactment.

SPECIAL NOTICE TO BLIND SSI RECIPIENTS (Sec. 6076)

Present Law.—No provision.

Committee Provision.—The Social Security Administration must give blind individuals receiving SSI the option (1) to receive a supplementary notice with respect to decisions or determinations related to their eligibility, by telephone, within 5 days after the initial notice is mailed; (2) to receive the initial notice in the form of a certified letter; or (3) to receive notification by some alternative procedure established by the Secretary and agreed to by the individual. The Secretary of HHS is required to study the desirability and feasibility of extending special or supplementary notices to other individuals who may lack the ability to read and comprehend regular written notices, and to make any appropriate recommendations within 12 months after enactment.

Effective Date.—The first day of the second calendar quarter to begin after the date of enactment. The Secretary must take appropriate steps, no later than one year after enactment, to ensure that every individual already receiving SSI benefits on the basis of blindness is given an opportunity to make the election provided above.

REHABILITATION SERVICES FOR BLIND SSI RECIPIENTS (Sec. 6077)

Present Law.—Benefits to an individual who is disabled may not be terminated, even though the individual's impairment has ceased, if the individual is participating in an approved vocational rehabilitation program and the Commissioner of Social Security determines that the completion or continuation of the program will increase the likelihood that the individual may be permanently removed from the disability rolls. There is no similar provision with respect to individuals who are blind.

Committee Provision.—Individuals whose blindness has ceased may continue to receive SSI benefits if they are participating in an approved vocational rehabilitation program, under the same conditions as are applied to the disabled.

Effective Date.—The first day of the second calendar quarter to begin after the date of enactment.

RETENTION OF MEDICAID FOR CERTAIN WIDOWS AND WIDOWERS (Sec. 6078)

Present Law.—The SSI statute requires individuals to apply for all other benefits for which they may be eligible. Thus, at age 60, disabled widows (or widowers) who apply for or are receiving SSI, are required to apply for early aged widow or widower social security benefits. (These benefits are actuarially reduced.) In cases where the resulting social security benefit is sufficient to preclude further SSI eligibility, the disabled widow or widower may lose Medicaid coverage.

Committee Provision.—An individual who would otherwise qualify for SSI on the basis of disability or blindness, but beginning at age 60 qualifies for social security early aged widow's or widower's benefits and loses eligibility for SSI, shall, nevertheless, be deemed to be an SSI recipient for purposes of eligibility for Medicaid. Eligibility for Medicaid will continue until such time as the individual becomes eligible for Medicare.

Effective Date.—Applies with respect to any individual without regard to whether the determination of his or her ineligibility for SSI benefits occurred before, on, or after the date of enactment; but no individual shall be eligible for assistance under title XIX by reason of this amendment before the first day of the second calendar quarter beginning after the date of enactment.

EXTENSION OF DEADLINE FOR CERTAIN WIDOW(ER)S TO APPLY FOR MEDICAID (Sec. 6079)

Present Law.—A provision in the 1983 social security amendments increased benefits for disabled widows and widowers. Because this benefit increase had the effect of making some individuals ineligible for SSI and therefore for Medicaid, a provision was later enacted to protect these individuals from loss of Medicaid by deeming them to be SSI recipients for purposes of Medicaid eligibility. The law provided a 15 month period (to July 1, 1987) during which individuals could file an application for Medicaid.

Committee Provision.—The period during which these individuals may file an application for Medicaid is extended to July 1, 1988.

Effective Date.—Upon enactment.

Part B—Other Provisions

SUBPART I—MEDICARE PROVISIONS

HOME HEALTH AND SKILLED NURSING FACILITY PROVISIONS (Sec. 6081)

(a) Home Health Toll-Free Hotline and Investigative Unit

Present Law.—The Secretary of Health and Human Services (HHS) enters into agreements with State or local agencies to survey and certify providers for participation in Medicare. There are no statutory requirements for toll-free hotlines and investigative units maintained by state or local agencies.

Committee Provision.—Agreements with State agencies who survey and certify home health agencies for participation in Medicare must provide for a toll-free hotline to collect, maintain and update certain information on Medicare-certified agencies in the State locality. This includes the date of the last survey of each agency, any significant deficiencies relating to patient care, any corrective actions planned or taken and any sanctions imposed. Agreements must also provide for a toll-free hotline to receive complaints and answer questions with regard to home health agencies in the State or locality, and for a unit to investigate these complaints. The unit will have enforcement authority and access to survey reports and consumer medical records.

Effective Date.—Effective with agreements entered into with State agencies on or after the date of enactment.

(b) Publication of Policies

Present Law.—No provision.

Committee Provision.—Fiscal intermediaries and carriers who administer Medicare benefits must make available to the public all interpretive materials, guidelines and clarifications of policies related to Medicare payments for home health and skilled nursing facility (SNF) services and durable medical equipment (DME) within six months of enactment. The Committee understands that this information may be most useful if published according to the format of the manual currently maintained by the Secretary of Health and Human Services.

The Secretary is required to publish, at least every three months, a list indicating the subject matter of home health, SNF DME coverage instructions and clarifications which have been provided to fiscal intermediaries, carriers or providers. This also includes interpretive rules, statements of policy, and policy changes issued by the Secretary, fiscal intermediaries or carriers. The Secretary is required to make available replacement pages to manuals or other documents used to disseminate policy information.

The Secretary is required to change policies or standards for payment, and fiscal intermediaries and carriers may only issue additional instructions, clarifications, rules, statements and guidelines for home health or SNF services and DME, in writing. These statements must be made available to fiscal intermediaries, carriers and providers (as well as to the Secretary when statements are issued by fiscal intermediaries or contractors). Policy changes or standards will only be effective for claims submitted 30 days after the written text has become available.

The Secretary is required to ensure that the practices of fiscal intermediaries and carriers are consistent and clearly understood by service providers and beneficiaries. The Secretary must consult periodically with beneficiaries, providers, intermediaries and carriers in updating and clarifying policies regarding SNF, home health and DME.

The Secretary is directed to the extent feasible, to make changes in automated data collection and retrieval systems to improve the accessibility of information about benefit denials, results of appeals, and other factors he deems relevant. This information should be retrievable by fiscal intermediary, provider and region. The Secretary is required to report to Congress within six months following enactment on the development of this data base, including the feasibility of including information on diagnosis, length of coverage, and reimbursement.

The Committee expects the Secretary to review materials provided under this section to ensure consistency and compliance with statutory requirements. Information should be furnished in as useful a manner as possible for providers and beneficiaries.

Effective Date.—Enactment.

(c) Conditions of Participation and Survey Process for Home Health Agencies

Present Law.—In order to participate in Medicare, providers and suppliers must comply with certain statutory requirements and with other requirements, specified by the Secretary, pertaining to patient health and safety. Together these requirements are known as "conditions of participation." The Secretary, under agreements with State agencies, periodically surveys Medicare providers for compliance with conditions of participation. There are no statutory requirements regarding the timing and process of the surveys.

Committee Provision.—Adds to the current conditions of participation for home health agencies a number of requirements including: protection and promotion of a patient's bill of rights; notification of State licensing agencies regarding hiring decisions and changes in ownership; a training program meeting minimum standards which must be promulgated by the Secretary by July 1, 1988; including in the patient's clinical records his or her plan of care.

These conditions are effective 18 months after enactment. It is the Secretary's responsibility to assure that the conditions of participation are adequate to protect the health and safety of patients and to promote effective and efficient operation.

The provision requires that a standard survey of each participating home health agency be conducted at least 9 months and no more than 15 months after the most recent survey. Surveys are also required upon a change of ownership or a significant number of complaints. Surveys may be made without advance notice and will include visits to a beneficiary's home (with his consent). Surveys will evaluate the quality of care and observance of the patient's bill of rights. The survey must be developed and validated by the Secretary by July 1, 1989. Surveyors must meet standards established by the Secretary by July 1, 1989 and are subject to conflict of interest provisions.

An extended survey will be conducted of home health agencies performing poorly in complying with the conditions of participation. The Secretary or the State agency may subject other agencies to the extended survey, which will be developed by the Secretary by April 1, 1990.

The Secretary is be required to evaluate the assessment process and report to Congress by January 1, 1992. The Secretary must provide for the training of State and Federal surveyors.

The Secretary is required to design procedures for evaluating plans of correction submitted by home health agencies out of compliance with the conditions of participation. The Secretary is authorized to impose intermediate sanctions short of termination for up to one year for such agencies if the agency's deficiencies do not immediately jeopardize the health and safety of patients. The Secretary is required to develop intermediate sanctions and a process for appealing them, which would include civil penalties and payment suspensions.

Effective Date.—Enactment.

(d) Denials and Reconsiderations

Present Law.—When a home health or skilled nursing facility (SNF) bill is submitted to a fiscal intermediary, a notice of determination of Medicare coverage is made and the beneficiary notified. Should the beneficiary request a reconsideration in writing, the intermediary makes a reconsideration determination which may in turn be appealed to an Administrative Law Judge.

Committee Provision.—Fiscal intermediaries are required to give to the provider and beneficiary a written explanation of any denial of a claim for home health or SNF services, including the statutory and regulatory basis for the denial, and to provide prompt notification of the decision on an claim for which a reconsideration has been requested.

For reconsiderations of denials made on the grounds that the service was not medically necessary, the denial must be reviewed by a physician and, if available, a physician with expertise in geriatrics. The committee recognizes that the requirement will have no direct spending effect on Medicare since contractor activities are funded by appropriations.

In evaluating the performance of fiscal intermediaries and carriers, the Secretary of HHS must take into account their ability to process 75 percent of provider home health, SNF and durable medical equipment reconsideration determinations within 60 days and 90 percent within 90 days, and the rate at which determinations are reversed. This requirement would be phased in over two years, so that in FY 1989 only, the standard would be 66 percent within 60 days.

Effective Date.—The notification and physician review requirements apply for claims submitted on or after January 1, 1988. The standards for prompt reconsideration apply beginning in fiscal year 1989.

(e) Moratorium on Prior Authorization for Home Health and SNF Services

Present Law.—The Omnibus Budget Reconciliation Act of 1986 (OBRA) required that the Secretary of Health and Human Services (HHS) conduct a demonstration project and report to Congress on the feasibility and desirability of prior authorization for home health and skilled nursing facility services in place of the current system of retrospective review. OBRA required that the demonstration be implemented by January 1, 1987. The Secretary is required to evaluate the projects and report back to Congress by February 1, 1989.

Committee Provision.—Prohibits the Secretary from proceeding to implement a national program of voluntary or mandatory prior authorization for Medicare home health and skilled nursing facility claims until six months after the Congress has received the final results of the Administration's evaluation of the studies required by the Omnibus Budget Reconciliation Act of 1986.

Effective Date.—Enactment.

(f) Fiscal Intermediary Consultation Requirement

Present Law.—The Secretary of Health and Human Services enters into agreements with fiscal intermediaries (FI's) to review and process claims under Medicare Part A. There is no explicit current law requirement that FI's consult with providers and consumers on a regular basis, although in practice, some FI's voluntarily do so.

Committee Provision.—Require that fiscal intermediaries (as a condition of their Medicare contract) have mechanisms for direct, periodic (but not less than annual) consultation with representatives of home health and skilled nursing home providers and consumers in their region and HCFA personnel regarding problems of claim review, coverage guidelines, reconsiderations payment, and other FI activities.

Effective Date.—January 1, 1988.

(G) Delay in Publishing Regulations With Respect to Deemed Status

Present Law.—The Secretary of Health and Human Services, under agreements with state agencies, surveys and certifies home health agencies for their compliance with conditions of participation in Medicare. there is no provision governing the "deeming" of accreditation for Medicare participation to private agencies or organizations.

Committee Provision.—Prohibits the Secretary from publishing final regulations providing for "deemed" status for home health agencies, until 6 months after publication of proposed regulations.

Effective Date.—Enactment.

(h) Home Health Prospective Payment System Study and Demonstrations

Present Law.—Under P.L. 97-414, the Secretary of Health and Human Services (HHS) is required to test alternative Medicare reimbursement methodologies for home health agencies.

The Health Care Financing Administration has done preliminary work on a demonstration of prospective payment for home health agencies, but has not actually implemented the demonstration.

Committee Provision.—The Secretary is required to conduct a study and demonstration of alternative methods for paying home health agencies under Medicare on a prosective basis. These methods must include payments on a per-visit, per-case and per-episode basis. The demonstration must consider the effects of these methods on access, quality, and operations, and must provide all necessary data for setting prospective payment rates. The demonstration must address whether a particular method will allow for prospective payment on a budget-neutral basis, and services provided under the demonstration must be provided on a budget-neutral basis. Services under the demonstration must be furnished by July 1, 1988.

The study and demonstration must account for the special needs of sole community and new home health agencies, extraordinary circumstances beyond an agency's control, the need to minimize administrative and reporting requirements to reduce program costs, variations in severity of illiness that cannot be accounted for by the reimbursement method, and cost increases.

The Committee directs the Secretary to consult with representatives of the home health industry before and during the demonstration, as well as in evaluating the demonstration and developing legislative proposals. The Committee understands that the Department has already devoted substantial efforts to developing a demonstration of prospective payment for home health, and expects the Secretary to make maximum use of these results where possible.

The provision requires the Secretary to submit an interim report to Congress on the demonstration within twelve months of enactment. Final legislative recommendations are due to Congress by July 1, 1990.

Effective Date.—Enactment.

(i) Study of Adjustments to Home Health Agency Cost Limits

Present Law.—Home health agencies participating in Medicare are paid reasonable costs subject to limits. Separate limits are computed for urban and rural home health agencies.

Committee Provision.—Requires the Secretary of HHS to study and report to Congress by June 1, 1988 on whether separate urban and rural home health cost limits accurately reflect differences in costs and the appropriateness of modifying the limits to take into account the proportion of patients from urban and rural areas.

The Committee has not included any provision extending eligibility for home health services on the basis of occupational therapy. The Committee expects the Congressional Budget Office to continue reviewing the feasibility of extending eligibility for home health on this basis in a cost-effective manner.

Effective Date.—Enactment.

(j) Beneficiary Notification of Coverage and Appeal Rights

Present Law.—Under program regulations beneficiaries must be informed in writing of their right to a reconsideration when they are mailed a notice of determination.

Committee Provision.—The provision requires that the Secretary develop a beneficiary notice of coverage and appeal rights under the Medicare program for the home health and skilled nursing facility benefits. The notice must be made available to beneficiaries by providers at the time that care is sought and by fiscal intermediaries at the time that a Notice of Determination is issued. The notice must specifiy: (1) beneficiary rights and conditions of coverage for home health and skilled nursing facility benefits; (2) beneficiary right to appeal for a coverage determination if a home agency or skilled nursing facility opts not to submit a claim for services on the beneficiaries behalf; (3) beneficiary right to appeal directly, or through a provider on their behalf, claims denied by the fiscal intermediary; and (4) the practical steps for initiating an appeal including sources of legal assistance.

The Committee recognizes that this requirement will have no direct spending effect on Medicare because contractor activities are funded by appropriations.

Effective Date.—Notices must be available no later than ninety days after the date of enactment.

OFFICE OF RURAL HEALTH (Sec. 6082)

Present Law.—No provision.

Committee Provision.—The provision establishes in the Department of Health and Human Services (HHS) an Office of Rural Health Policy to advise the Secretary on the effects of current policies and proposed statutory, regulatory, administrative and budget changes in Medicare and Medicaid on the financial viability of small rural hospitals and access to and quality of care. The Office will also establish and maintain a clearinghouse and coordinate activities relating to rural health care within HHS, and will provide information within HHS on activities of other Federal departments and agencies.

Effective Date.—Enactment.

SET-ASIDE FOR PROJECTS RELATING TO RURAL HEALTH CARE ISSUES (Sec. 6083)

Present Law.—There is currently no requirement that the Secretary of Health and Human services allocate a minimum level of funding at research on rural health concerns.

Committee Provision.—The provision requires that the Secretary set aside not less than 10 percent of amounts expended for Medicare experiments and demonstrations for projects related exclusively or substantially to rural health issues. This may include the impact of Medicare payment policies on the financial viability of small rural hospitals, on the ability of rural areas to attract and retain physicians and other health professionals, the appropriateness of Medicare conditions of participation for small rural hospitals and the impact of Medicare policies on access to and quality of rural health care.

The Secretary must establish and report to Congress annually on an agenda of rural experiments and demonstrations, including funding information.

Effective Date.—For fiscal years beginning with fiscal year 1989.

TECHNICAL AMENDMENTS RELATING TO CERTIFIED REGISTERED NURSE ANESTHETISTS (Sec. 6084)

Present Law.—The Omnibus Budget Reconciliation Act of 1986 provided for direct payment under Medicare for the services of certified registered nurse anesthetists (CRNAs). The provision will become effective in 1989. Payments will be made on the basis of a fee schedule established by the Secretary using audited cost data from fiscal year 1985, and updated annually. Payments may be made directly to the CRNA or to a hospital or physician that employs the CRNA.

Committee Provisions.—(1) The Secretary is authorized to use data, if necessary, in addition to audited 1985 cost reports, in establishing the fee schedule.

(2) A CRNA may authorize that payment be made to an ambulatory surgical center employing the CRNA, in addition to hospitals and physicians.

Effective Date.—Retroactive to the date of enactment of the Omnibus Budget Reconciliation Act of 1986.

COMMUNITY NURSING DEMONSTRATION (Sec. 6085)

Present Law.—No provision.

Committee Provision.—The Secretary is required to conduct a demonstration project involving at least four sites in underserved areas of a prepaid community nursing system. Qualified providers will be paid a capitated rate to provide community nursing services. Community nursing services include home health services and other Part B services (other than physician, X-ray, and lab services). The Secretary is required to submit a report to Congress no later than four years after enactment.

Effective Date.—Enactment.

WAIVER OF INPATIENT LIMITATIONS FOR CONNECTICUT HOSPICE (Sec. 6086)

Present Law.—Hospices participating in Medicare are required to maintain no more than 20 percent of total days as inpatient days. The Omnibus Budget Reconciliation Act of 1986 waived the 80/20 inpatient/home care day requirement for two years for Connecticut Hospice, Inc., provided it does not exceed 50 percent of total days as inpatient days. This waiver is effective until October 1, 1988.

Committee Provision.—Extends the waiver for 2 years.

Effective Date.—Enactment.

TECHNICAL CORRECTION RELATING TO CERTIFICATION OF PODIATRIC TEACHING PROGRAMS (Sec. 6087)

Present Law.—The Medicare statute refers to interns and residents that are in teaching programs approved by various certifying organizations, and specifically names (among others) the Council on Podiatry Education of the American Podiatry Association. In 1984 the name of this organization was changed.

Committee Provision.—Corrects the name of the organization—the Council of Podiatric Medical Education of the American Podiatric Medical Association.

Effective Date.—Date of enactment.

PROVISION OF SERVICES OFFSITE BY COMPREHENSIVE OUTPATIENT REHABILITATION AGENCIES (Sec. 6088)

Present Law.—Medicare covers services provided by comprehensive outpatient rehabilitation facilities (CORF's). Covered services include occupational, physical, and speech therapy, as well as other rehabilitation services. The Secretary of Health and Human Services has promulgated regulations that require that all services provided by a CORF must be provided at a "single fixed location" in order for the facility to be certified as a Medicare provider. Many facilities provide some therapy services at other locations such as the patient's home or at a satellite facility.

Committee Provision.—A CORF may provide occupational, physical, and speech therapy at sites other than the single location, provided that the therapy is provided as part of the individual's rehabilitation plan, and that no duplicate payments are made for the same service.

Effective Date.—Date of enactment.

ADMINISTRATIVE LAW JUDGES (Sec. 6089)

Present Law.—The Omnibus Budget Reconciliation Act of 1986 established administrative and judicial review procedures for Part B of Medicare comparable to those which had previously been in effect for Part A. Under Part A, administrative review was handled by administrative law judges located in the Social Security Administration. The Department of Health and Human Services (HHS), as part of its implementation of the Omnibus Budget Reconciliation Act provision, is developing policies which may transfer the administrative hearings function to the Health Care Financing Administration and provide for optional implementation of a telephone hearings process.

Committee Provision.—The Secretary of HHS is prohibited from making certain changes in the manner in which ALJ hearings are conducted until 6 months after a report to Congress. This includes maintaining within the Social Security Administration the function of hearing Medicare appeals and implementation of a telephone hearings process. The Secretary and the Comptroller General must report to Congress on the appropriateness of conducting telephone hearings.

Effective Date.—Enactment.

MORATORIUM ON LABORATORY PAYMENT DEMONSTRATIONS (Sec. 6090)

Present Law.—Pursuant to demonstration authority of present law, the Secretary has proposed to experiment with competitive bidding as a method of purchasing clinical laboratory services under the Medicare program.

Committee Provision.—The provision postpones the demonstrations until December 31, 1989.

Effective Date.—Date of enactment.

ELIMINATION OF SECOND MEDICARE WAITING PERIOD FOR CERTAIN REENTITLED DISABILITY BENEFICIARIES (Sec. 6091)

Present Law.—Individuals receiving cash social security disability benefits are eligible for Medicare after a two-year waiting period. In general, Medicare eligibility ends if an individual ceases to be entitled to disability benefits. (However, if an individual loses disability benefits solely on the basis of a return to work, he can retain Medicare coverage for up to three years after his cash benefits cease.)

If an individual becomes reentitled to disability benefit after he has been off the disability rolls for more than 5 years (7 years in the case of those receiving benefits as a disabled child or disabled widow or widower), he must serve a second 24 month waiting period before Medicare coverage is restored.

Committee Provision.—The Committee provision eliminates the requirement of a second Medicare waiting period for any beneficiary whose reentitlement to benefits is based on the same disability that was the basis for his previous period of eligibility (or is directly related to that disability).

Effective Date.—Effective with respect to reentitlements for individuals whose earlier period of entitlement to disability benefits ended in a month beginning more than 60 days after enactment.

HEALTH MAINTENANCE ORGANIZATION AND COMPETITIVE MEDICAL PLAN REFORMS (Sec. 6092)

(a) Civil Money Penalties and Intermediate Sanctions

Present Law.—The Secretary currently has the authority to impose a civil money penalty of $10,000 in each instance that a health maintenance organization or competitive medical plan (HMO/CMP) with a risk-sharing contract fails to provide medically necessary items and services required under law or contract to enrollees.

Also, the Secretary can impose intermediate sanctions, that is freeze enrollment or payment when an HOM/CMP fails to comply with the requirement that no more than 50 percent of its enrollees are beneficiaries of the Medicare or Medicaid programs.

Committee Provision.—Authorize the Secretary to impose civil money penalties or intermediate sanctions on eligible organizations that: overcharged on premiums; improperly failed to enroll, or improperly disenrolled, individuals; engaged in any practice to deny or discourage enrollment by individuals with a need for substantial medical services; misrepresented or falsified information; or failed to meet prompt payment standards for out-of-plan services. In addition, increase the penalty for failure to provide medically necessary items and services from $10,000 to $25,000.

Effective Date.—Date of enactment.

(b) Temporary Waiver for Watts Health Foundation

Present Law.—Medicare contracts on a risk-sharing basis with health maintenance organizations (HMOs) to provide services to Medicare beneficiaries enrolled in the organization. One of the requirements that an HOM must meet in order to qualify for a Medicare contract is that not more than 50 percent of its members may be Medicare or Medicaid beneficiaries. The Watts Health Foundation received a 3-year waiver of this requirement in 1985, which will expire in March, 1988. During the waiver period the organization increased its non-Medicare and Medicaid membership from 7 percent to 21 percent.

Committee Provision.—The waiver for the Watts Health Foundation is extended to January 1, 1990.

Effective Date.—Date of enactment.

(c) Social Health Maintenance Organizations

Present Law.—Under the Deficit Reduction Act of 1984, the Secretary of Health and Human Services approved waivers to establish a project to demonstrate the concept of a social health maintenance organization. The four demonstration sites selected were: SCAN Health Plan, Inc., Long Beach, California; Kaiser Permanente Medicare Plus II, Portland, Oregon; Seniors Plus, Minneapolis, Minnesota; and Elderplan, Inc., Brooklyn, New York. These sites are to provide for the integration of health and social services under the direct financial management of a provider of services. The Social HMOs are to enroll Medicare beneficiaries voluntarily in the HMO model and services are financed on a prepaid, capitated, at-risk basis. Operations began in the spring of 1985 and are scheduled to end in the fall of 1988.

Committee Provision.—The Secretary of Health and Human Services would be directed to extend without interruption, through September 30, 1992, the waivers granted under the Deficit Reduction Act of 1984 for the social HMO demonstration project under the same terms and conditions (other than duration of the project) established under the existing waivers. The Social HMOs would be at full risk in the third year and succeeding years. An interim report to Congress would be due by December, 1988, and a final report to Congress on the project would be due not later than March 31, 1993.

Effective Date.—Date of enactment.

(d) Payment Methodology Reform Demonstrations

Present Law.—Section 402 of the Social Security Amendments of 1967 provides authority to the Secretary of Health and Human Services to develop and engage in experiments and demonstrations for a variety of specified health care related services.

Committee Provision.—A new provision is added to the law specifically authorizing the Secretary to conduct three types of demonstrations of alternative payment methodologies pertaining to Medicare capitation projects.

The first new authority allows HHS to demonstrate methodologies in which adjustments to the rate paid to HMCs and CMPs (the adjusted average per capita cost) are made on the basis of health status. At present, the AAPCC is calculated on the basis of age, sex and welfare status.

The second new authority specifically provides that the Secretary demonstrate the concept of contracting with employer-based plans for Medicare services. Medicare currently contracts with HMOs and CMPs on a risk basis to provide the Medicare benefit package. Payment is at 95% of the adjusted average per capita cost. There is no authority for employer-based groups to contract with Medicare to combine their benefit packages with Medicare for their retirees.

The second new authority allows the Secretary to base payment on the experience of the employer-related group. All benefits would be offered to employees in a managed care setting. Election on the part of a beneficiary would be voluntary. A panel of specialists appointed by the Secretary in consultation with the House and Senate would review the demonstrations and advise on both ratesetting and appropriate measures to ensure high quality care.

The third new authority specifies that the Secretary demonstrate methodologies which consider geographic variations in cost as the basis for ratesetting. Among the concerns which have been raised with the current payment system for HMOs and CMPs is that geographic variation in the Medicare rates is disparate and does not accurately reflect the level of rates needed to serve the population in rural areas.

The third new authority provides for 6 demonstrations, all of which would consider geographic bases which may provide more equitable and appropriate payment than is currently provided on a county-by-county basis. All of the demonstrations would serve primarily geographic areas in which payment rates are below 80% of the median of the adjusted average per capita cost for all counties within metropolitan statistical areas. HMOs and CMPs physically located in urban areas who serve primarily populations from counties below the 80% payment level would be included in the demonstrations. Five million dollars in each of two years is authorized for methodologies concerning geographic variations in cost.

Effective Date.—Date of enactment.

(e) HMO/CMP Payments for Hospital Services

Present Law.—The Deficit Reduction Act of 1985 (DEFRA) allows the Medicare program to reimburse directly hospitals and skilled nursing facilities for non-contract services provided to a health maintenance organization's (HMO) and competitive medical plan Medicare enrollees. Direct program payments are made at the election of the HMO.

Committee Provision.—The option which allows the Medicare program to make direct payments would be eliminated. Hospitals would be required to accept prospective payment system (PPS) rates for all non-contract hospital services provided to HMO/CMP Medicare enrollees. Also, skilled nursing facilities (SNFs) would be required to accept for all non-contract skilled nursing facility (SNF) services rates which cannot exceed the SNF cost limits established by the Secretary. These payments would be made by the HMO/CMP. The Health Care Financing Administration would be required to provide to HMO/CMPs in machine-readable form Medicare DRG rates, as well as data on cost pass-through items, for all inpatient services provided to the Medicare eligible HMO/CMP beneficiary. The provision would only apply to HMO/CMPs that currently elect the direct payment option.

Effective Date.—April 1, 1988, or earlier if the Secretary can provide the needed data to HMOs/CMPs in machine-readable form.

(f) Optional 3-Year Contracts for HMO/CMPs

Present Law.—Medicare contracts with health maintenance organizations and competitive medical plans (HMO/CMPs) on a risk basis to provide the Medicare benefit package. Contracts are on an annual basis, although multi-year contracts are also authorized.

Committee Provision.—HMO/CMPs would be provided an option for three-year contracts. AAPCC rates for all three years would be set in advance, however, the Secretary would be permitted to offer to enter into the contracts at discounted rates.

Effective Date.—Date of enactment.

SUBPART II—MEDICAID PROVISIONS

HOME AND COMMUNITY-BASED SERVICES WAIVERS (Sec. 6101)

(a) New Waiver Authority

Present Law.—States may apply for waivers to provide home and community-based services to Medicaid recipients who would otherwise require the level of care provided in a hospital or nursing home. Under the waiver, the average per capita expenditure for covered individuals may not exceed the amount that would have been expended for those individuals without the waiver.

Committee Proposal.—The proposal creates new waiver authority under which the States can provide home and community-based services. A waiver will be granted if the State provides assurances that: 1) safeguards will be put in place to protect the health and welfare of individuals provided services, and to assure the financial accountability of program funds; 2) the need for skilled nursing facility or intermediate nursing facility services will be evaluated; 3) individuals in need of skilled nursing facility or intermediate facility care will be provided the option of such care or home and community-based care; and 4) the State will provide information to the Secretary on the impact of the waiver, the care provided, and the health and welfare of recipients.

Under a waiver, the requirements for statewideness, comparability, and income and resource rules applicable in the community are waived. Waivers shall be for an initial term of three years and, at the request of the State, shall be extended for additional five year periods.

Expenditures under a waiver for skilled nursing facility services, intermediate care facility services, and home and community-based services for individuals 65 years of age and older, may not exceed a projected amount. The projected amount for years prior to fiscal year 1990 equals the amount spent in the base year for such services increased by factors which take into account increases in 1) the cost of goods and services, i.e., a market-basket increase; 2) the over 75 year old population; and 3) the intensity of services. The base year is the most recent year prior to the date of enactment for which final Medicaid expenditures have been reported to, and accepted by the Secretary.

Current home and community-based services waivers scheduled to expire before July 1, 1988, will be extended through July 1, 1988, for those States that intend to use the new waiver authority.

The Committee recognizes that certain services such as the treatment of the developmentally disabled can only be provided in a home or community-based setting under waviers granted by the Secretary. The Committee wishes to explore legislation which will allow the States to meet the needs of the developmentally disabled in home and community-based settings under the program without the need for waivers. A proposal to achieve that goal, S. 1673, has been introduced by Senator Chafee. The Committee will hold hearings on the bill in the coming year.

Effective Date.—Date of enactment.

(b) Income Deeming

Current Law.—See section (a) above.

Committee Provision.—A technical correction would reinstate the authority of the States to use the income deeming rules applicable to nursing home patients for the beneficiaries receiving care under the waivers.

Effective Date.—Retroactive to the date of enactment of the Omnibus Budget Reconciliation Act of 1986.

(c) Participation Limits

Current Law.—See section (a) above.

Committee Provision.—The Secretary could not place a limit on the number of individuals receiving services under a waiver granted prior to March 12, 1985, where the limit is based on the unduplicated counting of individuals who receive home or community-based services or services in a nursing home or hospital.

Effective Date.—Retroactive to the date of enactment of the Omnibus Budget Reconciliation Act of 1986.

(d) Model Waivers

Present Law.—One type of home and community-based waiver, known as a "model waiver", allows States to cover home and community-based services for severly disabled individuals who would otherwise require institutional care and would be eligible for Medicaid if they were in an institution. The Secretary has set a limit for each State of 50 individuals who may be served under a model waiver.

Committee Provision.—Increases the 50-individual limit for model waivers to 200 individuals.

Effective Date.—Date of enactment.

(e) Technical Amendment Relating to Effective Date of Habilitation Services

Present Law.—The Consolidated Omnibus Budget Reconciliation Act of 1985 explicitly include habilitation services under the Medicaid home and community-based waiver program for individuals who receive these services after their discharge from a skilled nursing facility (SNF) or intermediate care facility (ICF). The effective date of the provision applied to services furnished on or after enactment (April 7, 1986). The Health Care Financing Administration has indicated to States that it intends to limit the coverage to services furnished to individuals who were discharged from the SNF or ICF on or after April 7, 1986.

Committee Provision.—Reaffirms that only the date on which the services are furnished is controlling, not the date of discharge.

Effective Date.—Retroactive to the date of enactment of the Consolidated Omnibus Budget Reconciliation Act of 1985.

TREATMENT OF GARDEN STATE HEALTH PLAN (Sec. 6102)

Present Law.—New Jersey has proposed establishing the Garden State Health Plan as a State owned and operated HMO and has requested HCFA's approval of this organization as an HMO. HCFA is unable to approve any entity as a Medicaid HMO unless there is a valid contract between the entity and the State. New Jersey wanted this entity to be able to offer a six-month lock-in and a six-month guaranteed eligibility. These two options are available only to Federally qualified HMOs and certain PHS and Appalachian health clinics.

Committee Proposal.—New Jersey's Medicaid agency is permitted to operate an HMO under section 1903(m). The State's Medicaid plan shall provide for establishment of an office within the State agency to operate an HMO meeting all requirements of section 1903(m). These provisions of the State plan will be treated as if they were a contract between the State agency and an HMO, and will be subject to approval by the Secretary in the same manner as any other contract between a State Medicaid agency and an HMO. The New Jersey HMO established in this fashion is authorized to guarantee eligible applicants a minimum enrollment period of six months, and to prohibit disenrollment without cause before the end of a six-month enrollment period.

Effective Date.—Date of enactment.

MEDICAID MATCHING RATES FOR QUALITY REVIEW OF HMO'S. (Sec. 6103)

Present Law.—Federal matching for Medicaid review activities conducted by PROs is 75 percent, while matching for general administrative costs is 50 percent. The Omnibus Budget Reconciliation Act of 1986 required States to provide an annual independent review of services furnished by health maintenance organizations (HMOs) to Medicaid beneficiaries. The review could be performed by a peer review organization (PRO) or by another private accreditation body. As a result of the 1986 provision, States will receive the higher matching rate if they choose a PRO to perform the reviews, rather than another accreditation body.

Committee Provision.—The matching rate for HMO review is 75 percent without regard to whether the review is carried out by a PRO or another accreditation body.

Effective Date.—Calendar quarters beginning on or after date of enactment.

PHYSICIANS' SERVICES FURNISHED BY DENTISTS (Sec. 6104)

Present Law.—State Medicaid plans are required to cover physicians' services, and have the option of covering dental services. State laws determine which procedures may be performed by dentists, and in most States dentists may perform some surgical procedures such as jaw surgery and reduction of jaw fractures. Some State Medicaid programs cover a procedure when performed by a physician, but not when performed by a dentist, despite the fact that both professionals are licensed to perform the procedure.

Committee Provision.—Requires State to cover any service performed by a dentist, which he is authorized and licensed to perform under State law, if that service is covered under the State plan when performed by a physician.

Effective Date.—January 1, 1988, with delay for States that must amend the State Medicaid plan by legislation.

NEW YORK STATE PILOT PROJECT FOR PRENATAL, MATERNITY AND NEWBORN CARE (Sec. 6105)

Present Law.—The Social Security Act contains general authority for Medicaid research and demonstration projects. Section 1915 provides for specific waivers to allow case management systems for Medicaid recipients.

Committee Provision.—The Secretary may grant waiver for three years for a New York State pilot project that provides prenatal, maternity and newborn care for pregnant women and newborns who are eligible for Medicaid or who would be eligible for Medicaid but for the free medical care provided under the project. Waivers are authorized to allow the projects on a less than Statewide basis, to establish eligibility as though the recipients had incurred the expenses paid by the program (if eligibility is established through a spenddown for medical expenses), to waive freedom-of-choice of providers after the recipient has voluntarily enrolled in the program, and to waive other requirements applicable to prepaid capitated plans necessary to carry out the project.

The Secretary's authority to grant waivers for the pilot project is permissive. The Committee notes that the pilot project is presently in the early planning stages, and the Secretary will need additional information before determining whether to grant the necessary waivers.

Effective Date.—Date of enactment.

MEDICAID WAIVER FOR HOSPICE CARE FOR AIDS PATIENTS (Sec. 6106)

Present Law.—States have the option of including hospice services under their State Medicaid programs. A hospice participating under the Medicaid program must meet the same requirements as for the Medicaid program. One of these requirements is that no more than 20 percent of the hospice services may be provided on an inpatient basis.

Committee Provision.—The Secretary is authorized to waive the 20 percent inpatient limit as it applies to Medicaid AIDS patients served by the hospice. The hospices would continue to be required to meet the requirement for its Medicare patients. The purpose of the waiver authority is to provide for situations such as one that currently exists in several New York hospices in which the hospice serves a large number of AIDS patients who are homeless or are too ill to be treated in their home environment.

Effective Date.—Date of enactment.

DELAY QUALITY CONTROL SANCTIONS FOR MEDICAID (Sec. 6107)

Present Law.—There is a moratorium on AFDC quality control error rate penalties, effective through June, 1988. The moratorium on Medicaid penalties has expired. A study of the quality control system by the National Academy of Sciences is expected to be issued in the near future.

Committee Provision.—The Medicaid error rate penalties are delayed through not be applied until the Congress has seen the results of the National Academy of Sciences' study.

Effective Date.—Applies to any penalties imposed prior to July 1, 1988.

SUBPART III—PROVISIONS RELATING TO SOCIAL SERVICES AND INCOME SECURITY

NATIONAL COMMISSION ON CHILDREN (Sec. 6111)

Committee Provision.—The Committee agreed to establish a bipartisan National Commission on Children. The Commission will be composed of 36 members: 12 appointed by the President; 12 by the Speaker of the House; and 12 by the President pro tempore of the Senate. The Commission will hold public hearings throughout the country on how to safeguard and enhance the physical, mental, and emotional well-being of children and youth. It is required to direct its attention to four specific areas of concern: health; social and support services for children and their parents; education; and income security.

In addition, the Commission will be asked to seek to identify ways in which public and private organizations and institutions can work together at the community level to identify deficiencies in existing services for families and children and to develop recommendations to ensure that the needs of families and children are met, using all available resources, in a coordinated and comprehensive manner.

The Commission will receive testimony from individuals, and from representatives of public and private organizations and institutions with an interest in the welfare of children, including educators, health care professionals, religious leaders, providers of social services, representatives of organizations with children as members, elected and appointed public officials, and from parents and children speaking on their own behalf.

The President, Speaker and President pro tempore will each appoint as members of the Commission: (1) four individuals who are representatives of organizations providing services to children, are involved in activities on behalf of children, or have engaged in academic research with respect to the problems and needs of children; (2) four individuals who are elected or appointed public officials involved in issues and programs relating to children; and (3) four individuals who are parents or representatives of parents or parents' organizations.

These appointments will be made in consultation with the chairmen of the committees of the House of Representatives and the Senate that have jurisdiction over relevant Federal programs. Appointments will be made not later than 60 days after the date of enactment. The Commission shall elect one of its members to serve as chairman.

The Commission is required to report to the President and the Congress by September 30, 1988, on its findings and recommendations. The Committee believes that this report will encourage all candidates running for public office in 1988 to pay close attention to children's issues, and to focus on how they believe the Nation can ensure the future well-being of our youngest citizens.

Effective Date.—Upon enactment.

BOARDER BABIES DEMONSTRATION PROJECTS (Sec. 6112)

Committee Provision.—The Committee bill authorizes $4 million a year for three years to fund demonstration projects to provide residential care for newborn babies whose parents abandon them to the care of hospitals. These "boarder babies" are frequently the offspring of drug addicts. They are generally healthy and do not require hospitalization, but New York and other cities have found it difficult to arrange alternative care.

The demonstration projects may include (1) projects designed to allow infants to remain with a parent in a residential setting, where appropriate care for the infant and suitable treatment for the parent (including treatment for drug or alcohol addiction) may be assured, with the goal of rehabilitating the parent and eliminating the need for such care for the infant; (2) projects that assure appropriate individualized care for such infants in a foster home or other non-medical residential setting in cases where the infant has been abandoned by the parent; and (3) such other projects as the Secretary of Health and Human Services determines will best serve the interests of such infants and will serve as models for projects that agencies or organizations in other communities may wish to develop.

In evaluating applications, the Secretary shall give priority to those projects that serve areas most in need of alternative care arrangements for such infants; provide for adequate evaluation; and meet such other criteria as the Secretary may prescribe. Grants may be used to pay the costs of maintenance and of necessary medical and social services (to the extent that these costs are not otherwise paid for under other titles of the Social Security Act), and for such other purposes as the Secretary may allow.

Effective Date.—October 1, 1987.

STUDY OF CHILDREN WITH AIDS IN FOSTER CARE (Sec. 6113)

Committee Provision.—The Committee agreed to authorize a study to determine the number of infants and children in the United States who are infected with the AIDS virus, or who have developed AIDS, who have been placed in foster care; the problems encountered by social services agencies in placing infants and children infected with the AIDS virus, or who have developed AIDS, in foster care; and the potential growth in the number of infants and children infected with the AIDS virus, or who have developed AIDS, who will require foster care over the next five years. The Secretary of Health and Human Services and the Comptroller General of the GAO will conduct the study. They are directed to make recommendations for improving the care of AIDS infants and children who lack ongoing parental involvement and support within one year after the date of enactment. The Secretary and the Comptroller General are directed not to duplicate activities by the Centers for Disease Control.

NEW YORK STATE DEMONSTRATION PROJECT (Sec. 6114)

Committee Provision.—The Committee agreed to allow the State of New York to test a child support supplement demonstration program as an alternative to the present Aid to Families with Dependent Children (AFDC) program. The Federal government will pay to the State with respect to families receiving assistance under the demonstration program the same amounts as would be payable with respect to the families as if they were receiving cash and medical assistance under the regular AFDC and Medicaid programs.

The State must provide assurances to the Secretary that the State will continue to make assistance available to all eligible children in the State who are in need of financial support, and will continue to operate an effective child support program. The State must also agree to have the program evaluated, and to report interim findings to the Secretary at such times as the Secretary provides. In addition, the State must satisfy the Secretary that the program will be evaluated using a reasonable methodology that can determine whether changes in work behavior and changes in earnings are attributable to participation in the program.

The State is required to submit its plan for the demonstration to the Secretary of Health and Human Services for his approval. Unless the Secretary or the Governor choose to terminate the project sooner, the demonstration will be conducted for a period not to exceed five years.

Effective Date.—Upon enactment.

WASHINGTON STATE DEMONSTRATION PROGRAM (Sec. 6115)

Present Law.—The State of Washington has passed legislation to undertake a five-year demonstration program, the Family Independence Program (FIP), as an alternative to the present Aid to Families with Dependent Children program. The legislation directs the Governor to enter into agreements with the Federal government to allow the State to proceed with the program. The Governor must submit those agreements and an implementation plan to the legislature by no later than February 7, 1988. The demonstration cannot proceed without Federal authorizing legislation.

Committee Provision.—The Committee agreed to allow the State of Washington to conduct a demonstration of its proposed Family Independence Program. The demonstration will emphasize education, employment and training services. The State must provide assurances satisfactory to the Secretary that the total amount of Federal reimbursement over the period of the project will not exceed the anticipated Federal reimbursement under the AFDC and Medicaid programs (including reimbursement for additional persons who would qualify for AFDC, and for costs attributable to increases in the State's payment standard).

Every individual eligible for aid under the State AFDC plan will be eligible to enroll in FIP, which shall operate simultaneously with the AFDC program so long as there are individuals who qualify for the latter. No family may receive less in cash benefits than it would have received under the AFDC program. Participation in work or training shall be voluntary during the first two years of the program, and may thereafter be made mandatory only in counties where more than 50 percent of the enrollees can be placed in employment within three months after they are job ready.

Effective Date.—Upon enactment.

REPEAL OF UNNECESSARY CHILD SUPPORT REVOLVING FUND (Sec. 6116)

Present Law.—States may in some circumstances request assistance from the Internal Revenue Service in collecting child support obligations. When IRS makes a child support collection on behalf of a State, the moneys collected are required by present law to be deposited in a revolving fund. They are disbursed from the revolving fund to the State for further distribution as though the State had made the collection directly. The revolving fund is not necessary since IRS could simply make the collection and turn the funds directly over to the State. By having a revolving fund, the money flows through the Federal budget although with no net budgetary impact since income to the fund is offset by outgo from the fund. In the event of a sequestration under the Balanced Budget and Emergency Deficit Control Act, however, these funds are subject to sequestration even though they are not Fedraal funds in any sense. Under the October 15, 1987 CBO sequestration report, a total of $39 thousand fom this account is projected to be sequestered in fiscal year 1988 under a full $23 billion sequestration.

Committee Provision.—The committee provision would replace the present law revolving fund mechanism with a simple requirement that any amounts collected by IRS under this procedure are to be transferred to the State requesting the IRS assistance.

Effective Date.—Upon enactment.

DEMONSTRATION TO ASSIST HOMELESS INDIVIDUALS IN OBTAINING SSI BENEFITS (Sec. 6117)

Present Law.—No provision.

Committee Provision.—The Committee agreed to authorize $1.25 million for fiscal year 1988, $2.5 million for fiscal year 1989, and such sums as may be necessary for fiscal years thereafter for projects to domonstrate and test the feasibility of developing and using special procedures to ensure that all homeless individuals in shelters fully and clearly understand their rights to benefits under the SSI program and other programs under the Social Security Act, to provide them with all possible assistance in applying for benefits and obtaining necessary documentation, and ensuring that they receive the benefits to which they are entitled. Up to 10 States would be allowed to create an SSI outreach team project. Individual projects could cost no more than $250,000 a year.

An outreach team project approved by the Secretary might work as follows:

The State's outreach team would be composed of a case worker from the State adult social services agency or from a local adult social services agency, who would serve as the team leader; a consultative medical examiner who is a physician/psychiatrist and who is qualified to provide consultative examinations for the Disability Determination Service of the State vocational rehabilitation service; a disability examiner from the State Disabiltiy Determination Service; and a claims representative from the Social Security Administration. Under an agreement between the Secretary and the State, each of the team members could be assigned by the individual's agency to serve on the team, and while doing so would retain the authroity to make decisions and determinations that the individual would have within the agency.

The teams established under a project would be assigned the responsibility for identifying homeless individuals who may qualify for SSI or other Social Security Act programs; ensuring that the individuals understand their rights under SSI or other programs; assisting individuals in applying for benefits and in obtaining and providing necessary information and supportive documents; and taking other steps necessary to ensure that homeless individuals receive the beneifits to which they are entitled. To the extent possible, all decisions, determinations, and other administrative actions would be provided at the shelters.

Effective date. October 1, 1987.

EXTENSION OF SSI INTERIM ASSISTANCE REIMBURSEMENT (Sec. 6118)

Present Law.—The Secretary may, upon written authorization by an individual, withhold benefits due to that individual and pay a State from the benefits withheld an amount sufficient to reimburse the State for interim assistance furnished the individual. This arrangement for reimbursing State for interim assistance paid to individauls may be used only in the case of payments that are made to an individual who is awaiting a determination of initial eligibility.

Committee Provision.—States may also receive reimbursement for interim assistance in cases where they have provided cash assistance to individuals whose SSI benefits were terminated or suspended, and subsequently have been found eligible for benefits.

Effective Date.—The 13th month follwing the month of enactment, or, if sooner, the first month for which the Secertary of Health and Human Services determines that it is administratively feasible.

SELF-EMPLOYMENT DEMONSTRATION PROGRAM (Sec. 6119)

Present Law.—Under existing law, workers who become involuntarily unemployed are entitled to receive unemployment compensation benefits under State benefit programs. In general, benefits are available for up to 6 months of unemployment. To qualifty for benefits, an individual must be able to work and must be available for work. If an individual attempts to set up his own business, he would be ineligible for further unemployment benefits since he would no longer be available to accept employment.

Committee Provision.—The provision would authorize a demonstration project under which States would continue paying unemployment benefits to unemployed persons who attempt to set up their own businesses. A maximum of three 3-year demonstration projects would be authorized. In each State, the number of participants could not exceed 3 percent of the start-of-year caseload of unemployment beneficiaries. In addition, the number of participants could not exceed the number of individuals who exhausted unemployment benefits during the previous year.

In order to participate in a self-employment project, a State would have to establish a program to assist claimants to set up businesses and would have to demonstrate that suitable conditions for creating new small businesses exist. States would have to establish the projects on a basis which would permit evaluation to show whether or not cost savings were achieved. States would be required to guarantee that no net additional costs in any fiscal year would accrue to the unemployment program as a result of the projects. (State general revenues would have to be used to meet administrative costs and to make up any operating loss to the unemployment program.)

Effective Date.—Upon enactment.

EXTENDED BENEFITS UNDER THE UNEMPLOYMENT INSURANCE PROGRAM (Sec. 6120)

Present Law.—The Budget Reconciliation Act enacted in December 1980 gave States three months to enact laws requiring work search by individuals receiving extended unemployment benefits (which are partially funded out of the Federal unemployment tax). Sixteen States failed to enact legislation within the required time. The Inspector General of the Department of Labor has found them out of compliance, and has determined that they should repay a total of $152 million to the Federal accounts in the trust fund.

Committee Provision.—The Committee bill amends the 1980 Act retroactively to give States six additional months to come into compliance. States whose legislatures did not meet in 1981 are given until October 1, 1982, to come into compliance. The 1980 law gave the States an unusually brief period within which to enact new legislation. This change establishes a more reasonable time frame for State action. The Congressional Budget Office considers the amendment to be budget neutral, because the $152 million would be shifted within the Federal budget from the State accounts to the Federal accounts in the unemployment trust fund.

Effective Date.—Upon enactment.

CBO COST ESTIMATE

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

October 19, 1987

Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate

Dear Mr. Chairman:

The Congressional Budget Office has prepared the attached cost estimate for your reconciliation package, as completed by the Committee on Finance October 16, 1987. The estimates assume CBO's reconciliation baseline. Estimates of these provisions would change if the August or Gramm Rudman baseline were used as the base. The $160 million in outlay reductions from the Medicare actions contained in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 are not included in the attached table.

If you wish further details on this estimate, we will be pleased to provide them.

With best wishes

Sincerely,

C.G. Nuckols
for Edward M. Gramlich
Acting Director

cc: Honorable Bob Packwood
Ranking Minority Member

ALL ESTIMATES ASSUME RECONCILIATION BASELINE

SENATE FINANCE COMMITTEE RECONCILIATION PACKAGE

10/19/87
07:53 PM

(All estimates are subject to final legislative language)
Estimates are in Millions of Dollars

TITLE VI -- COMMITTEE ON FINANCE

SUBTITLE -- HEALTH, SOCIAL SERVICES, INCOME SECURITY AND PBGC

	FY 88	FY 89	FY 90	3-Year Total
Part A Provisions with Major Budetary Impact				
Subpart I -- Provisions Affecting Medicare Part A				
Set PPS update for all hospitals at				
Urban Hospitals	1.0%	3.4%	4.1%	
Rural Hospitals	4.2%	3.4%	4.1%	
Exempt Hospitals	2.9%	5.4%	5.7%	
Savings	-500	-1455	-2385	-4340
Fix wage areas	0	0	0	0
Prohibit Bad debt change	0	0	0	0
Maryland waiver	0	0	0	0
Extend Sole community hospital Provisions	20	25	30	75
Rural Hospital cost Data Base (1)	1	1	*	2
Psychologists services to inpatients	0	0	0	0
Psychologists/conditions of partic.	0	0	0	0
Burn outliers	0	0	0	0

(Assuming Budget Neutral language)				
Rural impact analysis (1)	*	*	*	*
Mayo Clinic	0	0	0	0
Study urban/rural payment rates (1)	1	0	0	1
Wage index survey (1)	1	0	0	1
Hospital Outlier policy	0	0	0	0
Rural Referral Centers	0	0	0	0
Hospital Grants (Durenberger Amendment) (1)	0	15	15	30
UNOS	0	0	0	0
Indirect medical education (Reduce indirect adjustment to 6.9%)	-370	-525	-585	-1480
Rural Graduate Med Ed	0	0	0	0
Disproportionate share/PIP PIP Holiday in FY 89 and eliminate for all but small rural hospitals in FY 90 (2)	0	-365	-40	-405
Set hospital capital reduction at 10% in FY 88, 10% in FYs 89-90	-125	0	-585	-710
Rural R&D setaside	0	0	0	0
TOTAL OUTLAYS PART A	-975	-2320	-3565	-6860
TOTAL AMOUNTS TO BE APPROPRIATED	3	16	15	34

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Subpart II -- Provisions Affecting Medicare Part A and Part B

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Pay no Part A or B claim before the 10/11/12th day in 88/89/90 after receipt (2)	-490	-190	-210	-890
CORF prompt payment (2)	*	*	*	*
Payment safeguards - (Investment of $100 in medical review activities)	-50	-50	-50	-150
Medicare contractor budget (1)	0	0	0	0
Prohibit denial quotas (3)	0	0	0	0
Medicare secondary payer/ESRD	-2	-1	-1	-4
Clarification of State/Local Governments as Primary Payors for Working/Disabled	0	0	0	0
TOTAL OUTLAYS PART A AND PART B	-542	-241	-261	-1044
TOTAL AMOUNTS SUBJECT TO APPROPRIATION	0	0	0	0
Subpart III -- Provisions Affecting Medicare Part B				
Assistants/cataract surgery	0	0	0	0
Rehabilitation MD screens	0	0	0	0
MEI update: 3.2% Primary Care, 1% Non-primary Care Services	-155	-255	-285	-695
New physicians	-75	-125	-150	-350
Rural underserved bonus 5% bonus on assigned HMSA claims	0	35	60	95
Overpriced procedures Sliding scale to 150%	-40	-65	-75	-180

NHSC physician loan collection	-12	-16	-16	-44
Outpatient radiology	0	-75	-185	-260
Premium extension for 1 year	0	-375	-520	-895
Mental health limit at $1100	90	125	200	415
Mental health partial (assumes budget neutral language)	0	0	0	0
Eliminate ROE for Outpatient Hospitals	-25	-35	-40	-100
Rural clinics payment rate	3	4	5	12
Nurse midwives	*	*	*	*
Psychologists in RHCs	*	*	*	*
Psychologists in CMHCs	*	1	2	3
Therapeutic shoes	-25	-40	-45	-110
DME	-15	-20	-25	-60
Physician assts.	20	30	50	100
Eye & ear hospitals	0	1	2	3
Study of Anesthesia (1)	1	0	0	1
Report Date for PPRC	0	0	0	0
TOTAL OUTLAYS PART B	-234	-810	-1022	-2066
TOTAL AMOUNTS SUBJECT TO APPROPRIATION	1	0	0	0

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Subpart IV -- Provisions Affecting PRO's
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Teledox (1)	0	0	0	0
PRO due process report	0	0	0	0
PRO predenial notice	0	0	0	0
PRO funding levels	0	0	0	0
PRO contract requirements	0	0	0	0
PRO instate contracting	0	0	0	0
PRO review requirements	2	2	2	6
Provider/representing beneficiary	0	0	0	0
Beneficiary liability/quality denial	0	0	0	0
Beneficiary liability during appeal	0	0	0	0
TOTAL OUTLAYS PRO's	2	2	2	6
TOTAL AMOUNTS SUBJECT TO APPROPRIATION	0	0	0	0
Subpart V -- Provisions Affecting Medicaid				
Nursing home quality (S.1108)	6	95	166	267
Spousal impoverishment				
- $750 income	30	130	135	295
- $12,000 asset floor	25	115	130	270
- Tauke Amendment	15	65	75	155
- Transfer of Assets (7/1/88 effective date)	-30	-135	-145	-310
ICFMR plan of correction	0	0	0	0
Infant mortality program (S.422)	15	100	120	235

(7/1/88 effective date)				
Clarify newborn eligibility	0	0	0	0
OTA Study of Chronically ill children (1)	*	0	0	0
Puerto Rico--raise cap	11	11	11	33
Federal review of State IOC	-2	-2	-2	-6
Family planning outside HMOs	*	*	*	*
Income Disregard (Boren Amendment)	*	-1	-1	-2
TOTAL OUTLAYS MEDICAID	70	378	489	937
TOTAL AMOUNTS SUBJECT TO APPROPRIATION	0	0	0	*
Subpart VI -- Provisions Affecting Social Services and Income Security				
Increase Title XX funds	100	0	0	100
Titles XX and IVB	0	0	0	0
Foster care/child welfare	0	0	0	0
Voluntary foster care	0	0	0	0
Mother/infant foster care	3	3	3	9
Personal needs allowance				
SSI	9	12	12	33
Medicaid	20	33	33	86
Total	29	45	45	119
Increase emergency advances	*	*	0	*
Transfer of assets	*	*	*	*

Treatment of AFDC benefits	*	*	*	1
Exclude certain property	*	*	*	*
Burial account interest	*	*	*	*
Extend energy aid disregard	1	1	1	3
Exclude death benefits	*	*	*	*
Temporary institutional care	*	2	2	4
Couples in institutions	*	*	*	*
Eligibility in shelters	*	*	*	*
Special notices for blind	*	*	*	*
Rehabilitation for blind	*	*	*	*
Medicaid for widow(er)s	3	6	8	17
Extend medicaid deadline	*	*	*	*
TOTAL OUTLAYS	136	57	59	253
TOTAL AMOUNTS SUBJECT TO APPROPRIATI	0	0	0	0

	FY 88	FY 89	FY 90	3-Year Total
Part A Other Provisions				
Subpart I -- Provisions Affecting Medicare				
HHA standard & extended survey (Sec.8)	0	0	1	1
HHA toll free hotline (1)	*	*	*	*

HHA appeals procedures (1)	2	2	2	6
HHA publications of policies (1)	*	*	*	*
HHA prohibit prior authorization regulations	0	0	0	0
HHA MD Review (1)	5	5	5	15
Beneficiary Notification	0	0	0	0
Intermediary Consult	0	0	0	0
Deemed Status	0	0	0	0
Develop PPS for HHA	0	0	0	0
Study Urban/Rural Limits (1)	1	0	0	1
Connecticut hospice	0	0	0	0
Establish Rural health office (1)	1	1	1	3
Prohibition of ALJ Changes	0	0	0	0
Clinical Lab Moratorium	0	0	0	0
2nd waiting period/disabled	0	0	0	0
CORF offsite services	*	*	*	*
CRNA technicals	0	0	0	0
Podiatric accreditation	0	0	0	0
Nursing demonstrations (1)	0	0	0	0
Watts HMO	0	0	0	0
HMO intermediate sanctions	0	0	0	0

SHMOs	0	0	0	0
MIG & AAPCC Demo (1)	5	5	5	15
HMO Payments for Hospitals	0	0	0	0
Optional Three Year Contract	0	0	0	0
TOTAL OUTLAYS MEDICARE	0	0	1	1
TOTAL AMOUNTS SUBJECT TO APPROPRIATI	14	13	13	40
Subpart II-- Provisions Affecting Medicaid				
HCBW: budget-neutral formula	0	0	0	0
HCBW: unduplicated count	0	0	0	0
HCBW: income stds. technical	0	0	0	0
HCBW: define habitation	0	0	0	0
HCBW: 200 bed model waiver limit	0	0	0	0
Enhanced match for QROs	0	0	0	0
NY Pilot Project	0	0	0	0
NY Hospices	0	0	0	0
Dentists for surgery	0	0	0	0
Garden State	0	0	0	0
Delay GC Sanctions	0	0	0	0
TOTAL OUTLAYS MEDICAID	0	0	0	0

TOTAL AMOUNTS SUBJECT TO APPROPRIATION	0	0	0	0
Subpart III -- Provisions Affecting Social Services and Income Security				
Commission on Children (1)	1	0	0	1
Boarder babies demonstration (1)	1	4	4	9
Study of children with AIDS (1)	*	*	0	1
New York demonstration (1)	*	*	*	*
Washington demonstration (1)	*	*	*	*
Child support revolving fund	0	0	0	0
Outreach demonstrations (1)	1	2	2	5
Extend interim assistance	0	0	0	0
Self-employment demo	0	0	0	0
Extended benefit waiver	0	0	0	0
TOTAL OUTLAYS SS & INCOME SECURITY	0	0	0	0
TOTAL AMOUNTS SUBJECT TO APPROPRIATION	3	6	6	16
SUBTITLE B: pbgc				
Sec. 6629 PGBC Premium Increase	-390	-510	-540	-1440
SUMMARY OF OUTLAYS AND APPROPRIATED AMOUNTS				
TOTAL OUTLAY SAVINGS: MEDICARE AND MEDICAID	-1679	-2991	-4356	-9026

INCLUDING FREEZE				
TOTAL AMOUNTS SUBJECT TO APPROPRIATION: MEDICARE AND MEDICAID	18	29	28	74
TOTAL OUTLAY SAVINGS: MEDICARE, MEDICAID, SOCIAL SERVICES, INCOME SECURITY & PBGC	-1933	-3444	-4837	-10213
TOTAL AMOUNTS SUBJECT TO APPROPRIATION: ALL PROVISIONS	21	35	34	90

NA Not Available
* Less than $500,000
(1) Amount subject to appropriation
(2) These sections of bill must reference deficit reduction act to acheive savings.
(3) These sections particularly sensitive to legislation language.
(4) Many Medicare provisions require lead time in order to be implemented. Delay beyond November 21, 1987 may change those estimates.

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SUBTITLE B—REVENUE PROVISIONS

Part 1. Revenue-Raising Provisions

A. Accounting Provisions

1. Repeal of Completed Contract Method (sec. 6501 of the bill and section 460 of the Code)

Present Law

Taxpayers engaged in the production of property under a long-term contract must compute income from the contract under either the percentage of completion method or the percentage of completion-capitalized cost method. An exception is provided for certain small businesses with respect to construction contracts to be completed within two years.

Under the percentage of completion method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (1) the gross contract price and (2) the percentage of the contract completed during the taxable year. The percentage of a contract completed during the taxable year is determined by comparing costs incurred with respect to the contract during the year with the estimated total contract costs. In the taxable year in which the contract is completed, a determination is made whether the taxes paid with respect to the contract in each year of the contract were more or less than the amount that would have been paid if gross income had been computed by using the actual gross contract price and the actual total contract costs, rather than the anticipated contract price and costs. Interest must be paid by the taxpayer, if, applying this "lookback" method, there is an underpayment by the taxpayer with respect to a taxable year. Similarly, interest must be paid to the taxpayer by the Internal Revenue Service if there is an overpayment.

Under the percentage of completion-capitalized cost method, the taxpayer must take into account 40 percent of the items with respect to the contract under the percentage of completion method. The remaining 60 percent of the items under the contract must be taken into account under the taxpayer's normal method of accounting, for example, the completed contract method, income from a contract is included and contract costs are deducted upon final completion and acceptance of the contract. All costs that directly benefit or are incurred by reason of a taxpayer's long-term contract activities must be allocated to its long-term contracts in the manner provided in Treasury regulations under section 451 for extended period long-term contracts.

Reasons for Change

The committee believes that the current rules permitting a portion of a long-term contract to be reported on the completed contract method, an accrual method, or other method other than the percentage of completion method, permit an unwarranted deferral of income. Accordingly, the bill requires the use of the percentage of completion for all long-term contracts.

Explanation of Provision

Under the bill, income from a long-term contract must be reported under the percentage of completion method. A long-term contract is defined in the same manner as under present law. The bill preserves the present-law exceptions for certain construction contracts.

Effective Date

The provision is effective for contracts entered into after October 16, 1987.

2. Repeal of Vacation Pay Reserve (sec. 6502 of the bill and sec. 463 of the Code)

Present Law

Under present law, an accrual-method taxpayer generally is permitted a deduction in the taxable year in which all the events have occurred that detemine the fact of a liability and the amount thereof can be determined with reasonable accuracy (the 'all-events'' test). In determining whether an amount has been incurred with respect to any item during the taxable year, all events that establish liability for such amount are not treated as having occurred any earlier than the time economic performance occurs (sec. 461(h)). With respect to a liability that arises as a result of another persons providing services to the taxpayer (such as the liability to provide vacation pay in exchange for services by an employee), economic performance generally occurs when such other person provides the services.

In order to ensure the proper matching of income and deductions in the case of deferred benefits (such as vacation pay earned in the current taxable year, but paid in a subsequent year) for employees, an employer generally is entitled to claim a deduction in the taxable year of the employer in which ends the taxable year of the employee in which the benefit is includible in gross income (sec. 404(b)). This rule applies to deferred benefits without regard to the economic performance rules. Consequently, an employer is entitled to a deduction for vacation pay in the taxable year of the employer in which ends the earlier of the taxable year of the employee for which the vacation pay (1) vests (if the vacation pay plan is funded by the employer), or (2) is paid.

An exception to this rule applies to amounts that are paid within 2½ months after the close of the taxable year of the employer in which the vacation pay is earned. Such amounts are not subject to the deduction-timing rules applicable to deferred benefits, but are subject to the general rules under which an employer is entitled to a deduction when economic performance occurs (i.e., when the services of the employee for which vacation pay is earned are performed). Because amounts paid within 2½ months after the close of the employer's taxable year generally will qualify for the exception to the economic performance requirements, such amounts generally will be deductible for the preceding taxable year (the year in which the vacation pay is earned) even though the employee does not include the benefit in income in the preceding taxable year.

Under a special rule of present law, an employer may make an election under section 463 to deduct an amount representing a reasonable addition to a reserve account for vacation pay (contingent or vested) that is paid during the current taxable year or within 8½ months after the close of the taxable year of the employer with respect to which the vacation pay was earned by the employee.

Reasons for Change

The special rules under present law relating to the reserve for accrued vacation pay create a disparity in tax treatment beween accrued vacation pay and other deferred benefits. The committee believes that the timing of deductions for vacation pay should not be more favorable than the timing of deductions for other deferred benefits.

Explanation of Provision

The special rule that permits a taxpayers a deduction for additions to a reserve for vacation pay would be repealed. Accordingly, under the bill, deductions for vacation pay would be allowed in any taxable year for amounts paid, or funded amounts that vest, during the year or within 2½ months after the end of the year.

Effective Date

The provision would be effective for taxable years beginning after December 31, 1987. Taxpayers required to change their method of accounting under the bill for vacation pay are required to take the adjustment required under section 481 over a period not to exceed 4 years.

3. Changes in Installment Sales Rules (sec. 6503 of the bill and secs. 453, 453A, and 453C of the Code)

Present Law

Under present law, a taxpayer who sells property ordinarily must recognize gain or loss at the time of the sale. However, a taxpayer who is eligible to use the installment method may defer the payment of tax and recognize gain from a sale of property in proportion to the payments received.

In general, the installment method may be used to report gain from the sale of personal property by dealers in personal property who regularly sell on the installment plan, or for other sales of property where at least one payment is to be made after the end of the taxable year of the sale.

Under the installment method, in any taxable year, a taxpayer recognizes income resulting from a disposition of property equal to an amount that bears the same ratio to the payments received in that year that the gross profit under the contract bears to the total contract price ("the gross profit ratio"). Payments taken into account for this purpose generally include cash or other property (including foreign currency and obligations of third parties), marketable securities, certain assumptions of liabilities, and evidences of indebtedness of the purchaser that are payable on demand or are readily tradable.

Use of the installment method generally is limited under the so-called "proportionate disallowance rule" for dealer sales of real property and dealer sales of personal property eligible to be reported on the installment method, as well as for sales of real property used in the taxpayer's trade or business or held for the production of rental income where the selling price of such real property is greater than $150,000. Under the proportionate disallowance rule, a pro rata portion of the taxpayer's indebtedness is allocated to, and is treated as a payment on, the installment obligations of the taxpayer.

Use of the installment method is not allowed for sales pursuant to a revolving credit plan and for sales of publicly traded property. In addition, the installment method may not be used for purposes of the alternative minimum tax for sales that are subject to the proportionate disallowance rule.

At the election of the seller, installment obligations arising from certain sales of residential lots and "timeshares" are not subject to the proportionate disallowance rule. Rather, such taxpayers may compute their tax liability under the installment method and are required to pay interest on the amount of deferred tax attributable to the use of the installment method.

Dispositions of installment obligations

Generally, if an installment obligation is disposed of, gain (or loss) is recognized equal to either (a) the difference between the amount realized and the basis of the obligation in the case of a satisfaction at other than face value or a sale or exchange of the obligation, or (b) the difference between the fair market value of the obligation at the time of the disposition and the basis of the obligation in the case of any other disposition. The basis of the obligation is equal to the basis of the property sold plus the amount of gain previously recognized. In general, the mere pledge of an installment obligation as collateral for a loan is not treated as a disposition.[1]

Reasons for Change

The committee believes that the proportionate disallowance rule is inordinately complex and should be repealed. In addition, the committee believes that it is appropriate to repeal the installment method for dealer sales. The repeal of the installment method for dealers will end the ability of a company to defer tax on the normal sale of inventory by taking back a note receiveable that is payable in a future year, rather than using outside financing, revolving credit, or cash. The current taxation of sales of inventory for notes receivable does not create the significant cash-flow problems that the installment method is designed to alleviate because a business generally is able to finance receivables.

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[1] See, e.g., *Town and Country Food Co., Inc. v. Commissioner*, 51 T.C. 1049 (1969), acq. 1969-2 C.B. XXV; *United Surgical Steel Company, Inc. v. Commissioner*, 54 T.C. 1215 (1970), acq. 1971-2 C.B. 3.

In the case of nondealer installment obligations, the committee believes that nondealers that do not pledge installment obligations should be charged interest with respect to the amount of tax that is deferred. In addition, the committee believes that receipt of cash from the pledging of an installment obligation is an appropriate time to tax an amount equal to the gain element of the borrowed amount.

Explanation of Provision

Treatment of installment obligations arising out of dispositions of property by dealers

In general

The bill repeals the installment method for dispositions of property by dealers ("dealer dispositions") effective for taxable years beginning after December 31, 1987. All payments to be received from a dealer disposition of property are treated as received in the year of disposition.

Definition of dealer disposition

A dealer disposition is defined for purposes of the repeal of the installment method as any disposition of personal property by a person who regularly sells or otherwise disposes of property of such type on the installment plan. A dealer disposition also includes any disposition of real property that is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business. A dealer disposition does not, however, include certain dispositions of residential lots or "timeshares" if the taxpayer elects to pay interest on the amount of deferred tax attributable to the use of the installment method. Additionally, a dealer disposition does not include an installment obligation that arises from the disposition of property used or produced in the trade or business of farming.

Treatment of installment obligations arising out of nondealer dispositions of property

In general

The bill repeals the proportionate disallowance rule for nondealer installment obligations. Under the bill, an interest charge is imposed on the tax that is deferred under the installment method to the extent the amount of deferral exceeds $5 million. In addition, under the bill, if any indebtedness is secured by an installment obligation, the net proceeds of the secured indebtedness is treated as a payment on the installment obligation.

Interest charge on tax deferral

A nondealer is required to pay interest on the deferred tax that is attributable to the use of the installment method, to the extent that the aggregate face amount of installment obligations arising during a taxable year and outstanding as of the close of the year exceeds $5 million. The $5 million threshold does not apply to installment obligations that arise out of the sale of "timeshares" or residential lots. If the interest charge is applicable for any taxable year, it continues to apply until all payments under the installment obligations arising during the year are received, even though the aggregate face amount of the obligations may later be reduced below $5 million.

In determining whether the $5 million threshold has been exceeded, installment obligations that are pledged as security for a loan and installment obligations that arise out of the sale of "timeshares" or residential lots are not taken into account.

The amount of interest is computed from the date of the sale until the date that each payment under the obligation is received by applying the applicable Federal rate to the amount of tax that is attributable to the applicable percentage of payments received on the obligation during the year. The applicable percentage of payments received is determined by dividing (1) the portion of the aggregate face amount of installment obligations arising in and outstanding as of the close of the taxable year in excess of $5 million, by (2) the aggregate face amount of the installment obligations arising in, and outstanding as of the close of the taxable year.

Interest is not charged with respect to any payment that is received in the same taxable year as the sale that gave rise to the installment obligation. The interest payable under this provision is subject to the general rules regarding the deductibility of interest (see sec. 163). For purposes of the interest charge, the members of a controlled group are treated as a single taxpayer except to the extent provided otherwise in Treasury regulations.

Pledging of nondealer installment obligations

Under the bill, if a nondealer installment obligation is pledged as security for an indebtedness, gain generally is recognized equal to the product of the net loan proceeds [2] and the gross profit ratio applicable to the installment obligation. Receipt by the taxpayer of payments on the secured installment obligation subsequent to the time of the pledge generally does not result in recognition of additional gain, except to the extent that the gain that otherwise would be recognized on account of such payments exceeds the gain, if any, recognized as a result of the pledge. The rule relating to nonrecognition of gain from subsequent payments applies regardless of whether such payments are used to pay any portion of the indebtedness secured by the installment obligation. The total amount of gain that can be recognized on an obligation as a result of secured loans and the receipt of payments cannot exceed the gain that could be recognized on the obligation in the absence of the provision.

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[2] The net loan proceeds are equal to the gross loan proceeds less any expenses of obtaining the loan.

For purposes of this rule, an indebtedness is treated as secured by an installment obligation if the indebtedness and the installment obligation are part of a wraparound transaction. In addition, the bill provides Treasury with the authority to issue regulations that treat indirect pledges and other similar arrangements including general liens as payments on installment obligations.

The committee intends, for example, that where a parent corporation has a wholly-owned subsidiary that holds primarily installment obligations, and the parent pledges the stock of the subsidiary as collateral for a loan, the payments on the installment obligations may be treated as a source of payments required on the indebtedness. Similarly, the lender may be treated as relying on the installment obligations as a source of payment where a subsidiary holding primarily installment obligations borrows on an unsecured basis.

The provisions of the bill do not apply to the pledge of an installment obligation in connection with any indebtedness the terms of which require payment in full within 90 days of its issuance, provided the indebtedness is not extended, refinanced, or otherwise replaced during the 45-day period beginning on the day such indebtedness is repaid. The committee intends that indebtedness may be considered to be extended, refinanced, or otherwise replaced without regard to the identity of the new lender or the terms of the indebtedness.

Use of installment method for alternative minimum tax purposes

The bill does not change the treatment of installment obligations for purposes of the alternative minimum tax. Under the alternative minimum tax, income from the disposition of property is to be taken into account on the installment method only if the property disposed of is (1) real property used in the taxpayer's trade or business or held for the production of rental income and the sales price is less than $150,000; (2) property used or produced in the trade or business of farming; or (3) personal use property sold by an individual.

Effective Date

Installment obligations arising out of dealer dispositions

The repeal of the installment method for obligations arising out of dealer dispositions is effective for taxable years beginning after December 31, 1987. A taxpayer may elect, pursuant to regulations to be prescribed by the Treasury Secretary, to apply the amendments made by this provision to taxable years beginning before January 1, 1988, and ending after December 31, 1986, in which case the proportionate disallowance rule is not to apply.

A change from the installment method pursuant to the general effective date provision or the elective effective date is treated as a change in method of accounting that is initiated by the taxpayer and made with the consent of the Treasury Secretary. The net amount of the adjustment required by the change in method of accounting is to be taken into account under the principles of Rev.

Proc. 84-74, 1984-2 C.B. 736, but in no event is the adjustment to be taken into account over a period longer than 4 taxable years.

Installment obligations arising out of nondealer dispositions

The imposition of an interest charge with respect to nondealer installment obligations generally applies to obligations arising out of sales occurring after December 31, 1987, in taxable years ending after such date. The pledging rules generally apply to any installment obligation that is pledged to secure any indebtedness after October 16, 1987, in taxable years ending after that date.

A taxpayer may elect, pursuant to regulations to be prescribed by the Treasury Secretary, to apply (1) the interest charge to sales occurring after August 16, 1986, and before January 1, 1988, and (2) the pledging rules to pledges occurring after August 16, 1986, with respect to sales occurring after such date. If a taxpayer makes this election, the proportionate disallowance rule is not to apply to installment obligations that arise from sales occurring after August 16, 1986.

The bill does not apply to certain installment obligations that were specifically provided relief at the time the proportionate disallowance rule was enacted.

4. Amortization of Customer Base Intangibles and Similar Items (sec. 6504 of the bill and secs. 167 and 1253 of the Code)

Present Law

Taxpayers may take depreciation or amortization deductions for the exhaustion, wear, tear, and obsolesence of property (sec. 167(a)). No such deductions are allowed, however, with respect to property that is not a wasting asset or property whose useful life cannot be estimated with reasonable accuracy. Deductions are generally allowed for the costs attributed to such intangible assets as patents or other statutory or contract rights that exist for a specific, nonextendible period of time. However, because goodwill does not have a determinable useful life, no depreciation deduction is allowed with respect to that intangible asset. Accordingly, the portion of the purchase price of a business that is allocated to goodwill may not be amortized or depreciated. Goodwill has been defined as the expectancy of continued patronage, for whatever reason, or as the probability that old customers will resort to the old place.

Taxpayers frequently take the position that a substantial portion of the purchase price of a business is allocable to certain intangible assets other than goodwill, for which they attempt to establish a limited useful life and claim depreciation. The value of such other assets is often described as the value obtained from the existing customer base and the useful life is often said to be the time period over which that base may erode as customers move away or withdraw their level of patronage. Such assets include, for example, customer and subscription lists; patient or other client records; the existing "core" deposits of banks; insurance in force in the case of an insurance company; advertising relationships and customer or circulation base in the case of a broadcast, newspaper or similar business; location advantage; other contracts or relationships reflecting the value of the customer base; and existing market share in the case of any business.

In many instances, courts have refused to permit the amortization of such assets. The IRS has successfully argued that these items may be viewed as "mass assets" in that particular customers may be lost but others may be expected to replace them. Deductions have also been denied in many cases for such intangible assets as customer or client information that facilitates the business of serving customers. Such records have been described as simply an integral part of the goodwill of the business.

In some other cases, however, courts have permitted deductions for such items as customer lists or client information, stating that such assets are of use primarily as a resource for serving customers of the business but are not the same as goodwill. Still other cases have denied the deductions claimed in the particular case, but have suggested that if the taxpayers had presented better statistical evidence of the period over which the existing customer base declined, amortization might be permitted. The cases permitting or suggesting the possibility of a deduction have not always indicated whether it is necessary to take into account any expectation or evidence that new customers will replace those that die, move away, or otherwise sever their customer relationships.

Generally, costs attributable to the creation or acquisition of an asset that has a useful life of more than a year may not be currently deducted, but must be capitalized. Goodwill typically would have a life extending beyond one year and costs that can be related to its creation, such as those of certain extraordinary advertising campaigns, are required to be capitalized. However, it is possible that many taxpayers deduct current costs that may contribute to the creation of goodwill, such as ordinary advertising or other ongoing business expenses. This may occur in part because of the difficulties of separately identifying which ordinary and necessary business expenses have created goodwill, and of determining when or whether "new" goodwill has been created.

Going concern value is also not considered a depreciable or amortizable asset, due to the difficulty of establishing a determinable useful life for such an asset. However, some taxpayers take the position that assets such as "workforce in place" have a determinable useful life and are amortizable. At the same time, such taxpayers frequently do not capitalize the costs of recruiting and training new employees who replace those who retire or otherwise sever their employment.

When a franchise, trademark, or tradename is transferred, payments on account of such transfer are allowed as an ordinary and necessary business deduction if they are contingent on the productivity, use, or disposition of the franchise, trademark, or tradename. If a transfer is not treated as a sale because the transferor retains any significant power, right or continuing interest with respect to the subject matter of such asset, then any payment of a principal sum agreed upon in the transfer agreement is deductible over a period not exceeding 10 years (sec. 1253(d)(2)).

Reasons for Change

The committee believes that assets that share many of the characteristics of goodwill and going concern value should not be amortized or depreciated more rapidly than such assets. Assets that are essentially renewing through the expenditure of amounts that are not capitalized should not be depreciable or amortizable.

The determination whether assets representing the value of existing customer base or market share, or renewable other assets, have a determinable useful life has been an endless source of controversy between the Internal Revenue Service and taxpayers. The Service lacks the resources to challenge amortization or depreciation deductions taken for such assets or to establish the extent of the renewal of the asset in many cases.

The committee believes it is appropriate to deny amortization or depreciation deductions for intangible assets representing the value of existing customer base or market share. The committee also believes that such deductions should be denied for other renewing assets, which are renewed through the expenditure of amounts deducted currently.

Taxpayers have taken the position that the acquisition of all of a transferor's interest in a franchise, trademark, or tradename by a transferee of the business permits the transferee to deduct over no less than ten years the purchase price attributed to such franchise, trademark, or tradename under section 1253(d)(2) of the Code. Certain private letter rulings issued by the Internal Revenue Service appear to have endorsed this position, in spite of the fact that the literal language of the statute has not been satisfied in such cases because the transferor has not retained any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or tradename. *See, e.g.* ltr 8730085 (July 24, 1987). The committee believes that such an application of section 1253(d)(2) potentially to permit the amortization over ten years of assets that may have a longer and frequently indeterminate useful life is inappropriate under existing law.

Explanation of Provision

The bill clarifies that any amount paid or incurred to acquire customer base, market share, or any renewing or similar intangible item is treated as paid or incurred for intangible property with indeterminate useful life, and therefore is not amortizable or depreciable.

The items covered include, for example, customer and subscription lists; patient or other client records; the existing "core" deposits of banks; insurance in force in the case of an insurance company; advertising relationships and customer or circulation base in the case of a broadcast, cable, newspaper, cellular, or any other business; other contracts or relationships reflecting the value of the customer base; location advantage; workforce in place; and market share in the case of any business.

In addition, any asset that is renewed through the expenditure of costs that are currently deductible is not amortizable or depreciable.

The committee believes that the value of items such as franchises, trademarks, and tradenames if often largely attributable to a customer base or market share. The committee expects that a significant portion of the value attributed to such rights will generally be considered attributable to an asset of indeterminate useful life under the principles of the bill, even if the contract under which such rights are obtained has a fixed and determinable, nonextendible useful life. In any event, the bill is intended to clarify that section 1253(d)(2) does not apply to any payment made by the transferee of a franchise, trademark, or tradename to a transferor who does not retain any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or tradename. The fact that another party who is not the transferor may retain such a right thus does not permit the transferee to deduct any amount under section 1253(d)(2).

No inference is intended as to prior law.

Effective Date

The provision applies to acquisitions after October 15, 1987, unless pursuant to a binding written contract in effect on that date and at all times thereafter.

B. Estimated Tax Provisions (secs. 6511–6513 of the bill, sec. 1541 of the Reform Act, and secs. 3402, 6654, and 6655 of the Code)

1. Mitigation of Estimated Tax Penalties for 1987 (sec. 6511)

a. Delay of increase in current year liability test for individuals

Present Law

Individuals owing income tax who do not make estimated tax payments are generally subject to a penalty (Code sec. 6654). In order to avoid the penalty, individuals must make quarterly estimated tax payments that equal at least the lesser of 100 percent of the prior year's tax liability or 90 percent of the current year's tax liability. Amounts withheld from wages are considered to be estimated tax payments.

The Tax Reform Act of 1986 increased from 80 to 90 percent the proportion of the current year's tax liability that taxpayers must pay to avoid the penalty. This was effective for taxable years beginning after December 31, 1986.

Reasons for Change

The committee believes that it is appropriate to provide estimated tax relief to individuals for 1987, due to the difficulties a number of individuals had with Form W-4 and with other provision of the 1986 Act.

Explanation of Provision

The bill delays for one year this increase from 80 to 90 percent. Thus, for taxable years beginning before January 1, 1988, individuals may avoid the estimated tax penalty by making quarterly estimated tax payments that equal at least the lesser of 100 percent of the prior year's tax liability or 80 percent of current year's tax liability. For taxable years beginning after December 31, 1987, individuals may avoid the estimated tax penalty by making quarterly estimated tax payments that equal at least the lesser of 100 percent of the prior year's tax liability or 90 percent of the current year's tax liability.

Effective Date

The increase from 80 to 90 percent is effective for taxable years beginning after December 31, 1987 (instead of taxable years beginning after December 31, 1986).

b. Corporations may use 1986 tax to determine certain estimated tax installments due before July 1, 1987

Present Law

No estimated tax penalty is imposed upon a corporation with respect to any installment if that installment plus all prior installments for the year are based on the lesser of (1) the preceding year's tax liability, if a return showing a liability for tax was filed for the preceding year; (2) the tax computed by using the facts shown on the prior year's return under the current year's tax rates; or (3) 90 percent of the taxes which would be due if certain income already received during the current year were placed on annual basis. Large corporations may not use exceptions (1) and (2) described above. A large corporation is defined as a corporation having at least $1 million of taxable income in any of the three prior taxable years.

Present law does not give explicit authority to the Treasury to provide alternative estimated tax rules for corporations.

The Treasury has issued regulations, applicable to estimated tax payments due before July 1, 1987, that permit corporations to base those estimated payments on 120 percent of 1986 taxable income with certain modifications.

Reasons for Change

Because of the numerous changes made by the Tax Reform Act of 1986, some corporations had difficulty in accurately computing their estimated tax payments for the first part of 1987. Therefore, the committee believes that it is appropriate to provide relief from the estimated tax penalties for those payments.

Explanation of Provision

Two safe harbors are provided for corporate estimated tax payments due before July 1, 1987. First, all corporations, including large corporations, are permitted to base those estimated tax payments on 100 percent of the 1986 tax liability. Second, statutory authorization is provided for the safe harbor provided in the Treasury regulations.

Under the first safe harbor, no penalty for the underpayment of estimated tax for a taxable year beginning in 1987 will be imposed on a large corporation (as defined in sec. 6655(i)(2) of the Code) for any payment due on or before June 15, 1987, if the corporation's estimated tax payment meet the present law requirements (of sec. 6655(d)(1)) applicable to other corporations allowing payments to be based on the tax shown on the prior year's return. Thus, large corporations are expressly authorized to utilize the estimated tax safe harbor of paying the preceding year's tax liability for estimated tax installments for taxable year 1987 due on or before June 15, 1987. A corporation may take advantage of this rule only to the extent that the underpayment of estimated tax is paid on or before the last date prescribed for payment of the most recent installment of estimated tax due on or before September 15, 1987. This relief is available for the first two payments of a calendar year corporation and for the first payment of a fiscal year corporation whose taxable year begins on or before March 1, 1987.

Thus, a calendar year corporation may avoid an estimated tax penalty by making the April 15 and June 15 installments based on 100 percent of the preceding year's liability and by making the September 15 installment based on 90 percent of the current year's tax liability (and by paying any shortfall from prior payments attributable to the difference between the 100 percent test and the 90 percent test as part of the September 15 installment).

Effective Date

The provisions are effective for corporate estimated tax installments for 1987 that were due before July 1, 1987.

2. Revised Withholding Certificates Required To Be Put Into Effect More Promptly (sec. 6512)

Present Law

If an employee furnishes to his or her employer a withholding allowance certificate (Form W-4 or W-4A) that replaces an existing certificate, the employer must make the certificate effective no later than the first status determination date that is at least 30 days after the date the employee furnishes the certificate to the employer. The status determination dates are January 1, May 1, July 1, and October 1 of each year. For example, if an employee furnishes a replacement withholding allowance certificate to his or her employer on June 2, the employer must make that certificate effective no later than October 1.

Employers may elect to make replacement certificates effective earlier than they are required to statutorily; most employers elect to do so.

Reasons for Change

The committee believes that it is appropriate to reduce the amount of time before a replacement withholding certificate must become effective.

Explanation of Provision

Employers will be required to give effect to replacement withholding allowance certificates (Form W-4 or W-4A) no later than the start of the first payroll period ending on or after the thirtieth day after the day on which the employee furnishes the certificate to the employer. Employers are permitted to continue to elect to give effect to replacement withholding allowance certificates on any date between the date it is furnished by the employee and the statutorily mandated effective date.

Effective Date

The provision applies to replacement withholding allowance certificates furnished after the day 30 days after the date of enactment of the bill.

3. Corporate Estimated Tax Reform (Sec. 6513)

Present Law

Under present law, a corporation that fails to pay an installment of estimated income tax on or before the due date generally is subject to a penalty computed at the rate of interest for tax underpayments. The penalty may not be waived. The penalty is computed by applying the underpayment interest rate to the amount of the underpayment of the installment for the period of the underpayment. The amount of the underpayment is the difference between the payments made on or before the due date of each installment and 90 percent of the total tax shown on the return for the year, divided by the number of installments that should have been made. The penalty on underpayments of estimated tax that are between 80 percent and 90 percent of the actual tax due is imposed at three-quarters of the full rate.

There are three exceptions to the penalty. No penalty is imposed upon a corporation if total tax payments for the year equal or exceed installments based on (1) the preceding year's tax liability, if a return showing a liability for tax was filed for the preceding year; (2) the tax computed by using the facts shown on the prior year's return under the current year's tax rates; or (3) 90 percent of the taxes which would be due if certain income already received during the current year was annualized. Large corporations may not use exceptions (1) and (2) described above. A large corporation is defined as a corporation having at least $1 million of taxable income in any of the three prior taxable years. No penalty is imposed where the tax is less than $40.

Reasons for Change

Although the individual estimated tax rules were consolidated and simplified in 1984, no similar consolidation and simplification was done for the corporate estimated tax rules. The committee believes that it is appropriate to do so. The committee also believes that, because of the difficulties many large corporations experience in computing accurately their estimated tax payments for the first quarter, it is appropriate to provide for them for that quarterly payment the same safe harbor that is currently available to small corporations.

Explanation of Provision

The bill consolidates all the corporate estimated tax rules into one section of the Code, similar to the provision enacted for individuals in 1984. Also, several modifications are made to present law.

The underpayment penalty with respect to any installment applies to the difference between payments made by the due date of the installment and the lesser of an installment based on (1) 90 percent of the tax shown on the return; or (2) 100 percent of the tax shown on the preceding year's return. As under present law, exception (2) generally does not apply to a large corporation, except that a large corporation could use that exception for purposes of making its first estimated payment for any taxable year. Thus, both large and small corporations may base their first estiamted tax payment of any taxable year upon 100 percent of the tax shown on the preceding year's return. In determining whether a corporation is a large corporation because it's taxable income exceeds $1 million, net operating loss and capital loss carryforwards and carrybacks are disregarded. The safe harbor of the previous year's facts and the current year's rates is eliminated.

In addition, the full rate of the penalty is imposed with respect to any payment only to the extent the total payments for the year up to the requried installement are below 90 percent of the taxes which would be due if the income already received during the current year was placed on an annual basis. Thus, the "cliff" effect of the penalty under present law is eliminated. Additionally, the reduced rate of the penalty for underpayments that are between 80 and 90 percent is eliminated. Any reduction in a payment resulting from using the annualization exception must be made up in the subsequent payment if the corporation does not use the annualization exception for that subsequent payment.

Finally, no penalty is imposed if the tax for any taxable year is less than $500.

Effective Date

This provision applies to taxable years beginning after December 31, 1987.

C. Corporate Tax Provisions

1. Computation of Earnings and Profits for Purposes of Intercorporate Dividends and Basis Adjustments Under Consolidated Return Provisions (Overruling of *Woods Investment Co.*) (secs. 6521 and 6525 of the bill and secs. 1503 and 301(f) of the Code)

Present Law

In general, an affiliated group of corporations may elect to file a consolidated return that aggregates the income and deductions of the common parent and its subsidiaries. An affiliated group generally includes a domestic corporation and its domestic subsidiaries connected in a chain of at least 80-percent ownership. The Code grants the Treasury Department broad authority to issue regulations governing the computation of the tax liability of an affiliated group of corporations filing a consolidated return.

In 1966, the Treasury Department issued revised consolidated return regulations requiring adjustment of a parent corporation's basis in the stock of a subsidiary by reference to changes in the earnings and profits of the subsidiary. The regulations require a parent corporation to increase its basis in the stock of a subsidiary by the amount of the undistributed net earning and profits of the subsidiary for the taxable year, and to reduce its basis in such stock by the amount of any deficit in earnings and profits, among other adjustments. At the time these regulations were issued, differences between earnings and profits and taxable income were essentially permanent as opposed to timing differences. The result was that adjustments to basis of the assets of a subsidiary were reflected immediately as adjustments to the parent corporation's basis in stock of the subsidiary.

Subsequently, Congress enacted amendments to the provisions of the Code defining earnings and profits. As a result of these amendments, certain deferral amounts affected earnings and profits at a different rate than they affected a corporation's taxable income. For example, earnings and profits were reduced only by the amount of straight-line depreciation, even though accelerated depreciation was used for purposes of computing taxable income. Similarly, gain reported on the installment method and income reported under the completed contract method were included in earings and profits at a faster rate than for taxable income purposes.

The purpose of these amendments to the definition of earnings and profits was to prevent corporations with economic profits from making distributions to individual shareholders that would otherwise constitute tax-free returns of capital, or capital gains taxed at a preferential rate, to the shareholder. In a consolidated return context, however, the effect of applying these amendments in computing basis adjustments was to create a disparity between the rate at which these items reduced or increased a parent's basis in the stock of its subsidiary and the rate they reduced or increased the group's consolidated taxable income. Because of these earnings and profits adjustments, a parent corporation could sell stock in a subsidiary and recognize an artifically reduced gain, or an artificial loss.

In *Woods Investment Co.* v. *Commissioner*, 85 T.C. 274 (1985), the Tax Court rejected the Internal Revenue Service's argument that the taxpayer should not be allowed to apply these amendments for purposes of computing basis adjustments because the effect was to allow the taxpayer a double deduction. The court held the Service was bound by a literal application of the statutory definition of earnings and profits and its own regulations requiring basis adjustments based on earnings and profits. The Service subsequently announced that it would not apeal this decision and would not reassert the position taken in *Woods* against other taxpayers (Announcement 86-32). It nonetheless took the position that its position in *Woods* was correct, and stated that it was considering modification of the consolidated return regulations to prevent understatement of gain in that situation and other situations.

A similar issue arises in a consolidated return context where an insolvent subsidiary realizes cancellation of indebtedness income. The earnings and profits of the subsidiary may be increased by the amount of such income, even though the income is excluded from the subsidiary's taxable income. If so, the parent corporation's basis in the stock is increased (or its "excess loss account" or negative basis is reduced) by an amount that has not been reflected in consolidated taxable income.

A benefit similar to that at issue in the *Woods* case may exist where the distributor and distributee do not file a consolidated return. Special rules prevent the occurrence of these distortions in certain circumstances.[1] If a 20-percent or more corporate shareholder receives a distribution from another corporation that would otherwise qualify for the dividends received deduction, the taxable income of the shareholder (and its adjusted basis in the stock of the distributing corporation) is determined by ignoring certain adjustments otherwise required in determining the earning and profits of the distributing corporation (sec. 301(f)).[2] That is, the earnings and profits treatment of the items is conformed to the taxable income treatment. These special conformity rules do not apply, however, to depreciation.

Reasons for Change

The committee believes that the present consolidated return regulations, as applied in the *Woods* case, confer an unwarranted and unintended tax benefit. Under present law, the adjustment in the basis of a subsidiary's stock fails to account for the tax benefits realized by the consolidated group during the subsidiary's affiliation and also fails to require the group to pay tax on the economic profit received when a subsidiary is sold. The original justification for the consolidated return provisions of the Code was that the individual members of a controlled group of corporations should, as a matter of equity and convenience for both the government and the taxpayer, be taxed as a single business unit.[3] Yet the current consolidated return regulations may produce consequences on disposition of a subsidiary that are substantially more favorable than if the parent and its subsidiary were a single corporation.

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[1] It is unclear whether and to what extent these special rules apply in a consolidated return context, but the committee understands that taxpayers generally take the position they do not.

[2] Section 301(f) is redesignated section 301(e) in the Technical Corrections title of the bill.

The committee believes that the consolidated return regulations may appropriately provide rules that allow more favorable consequences for distributions and transactions among members of an affiliated group of corporations filing a consolidated return than if the transactions were among nonmembers (for example, allowing deferral of gain on intragroup sales of property until the property is sold outside the group). Moreover, these rules may appropriately make adjustments to the basis of stock in a subsidiary to avoid recognition of gain on the disposition of stock in a subsidiary, where such gain reflects undistributed earnings of the subsidiary that have been included in consolidated taxable income and taxed to the group during the period of the subsidiary's affiliation with its parent. Nonetheless, the committee does not believe that the consequences of a disposition of stock in a member of the group should be more favorable than if the operations of the subsidiary had been conducted (and the assets had been owned) directly by the parent corporation. The amendments made by this provision are intended to prevent this result, and the committee expects that appropriate modifications will be made not only to the basis adjustment rules, but to other provisions of the consolidated return regulations, in furtherance of this objective.

In the committee's view, an increase in basis in stock with respect to any deferral item should be permitted only to the extent that an item of income or gain that has accrued to the subsidiary during its affiliation with the parent has actually been reflected in consolidated taxable income; no increase should be allowed with respect to gain that remains inherent and unrealized at the time the subsidiary leaves the group, whether such gain is attributable to the appreciation of assets above their original cost or to an excess of tax depreciation over economic depreciation.

The committee believes that the provision of present law modifying the definition of earnings and profits in the case of distributions to 20-percent or more corporate shareholders should apply to depreciation as well as to the items specified in section 312(n).

Explanation of Provision

Under the bill, solely for purposes of determining gain or loss on disposition, a parent corporation's basis in the stock of a subsidiary with which it files a consolidated return is to be determined by computing earnings and profits of the subsidiary without regard to sections 312(k) and (n). Thus, the parent's basis for purposes of determing gain or loss on disposition of the stock will be computed as if, throughout the period of the subsidiary consolidation with the parent, the subsidiary's earnings and profits had been computed without regard to the special adjustments for depreciation and other items.[4]

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[3] S. Rept. No. 617, 65th Cong., 3d Sess. 9 (1918).

In addition, the bill provides that earnings and profits for this purpose does not include any cancellation of indebtedness income of the subsidiary excluded under section 108 to the extent such income did not reduce basis of property or other tax attributes.

Finally, the bill expands the provisions modifying the definition of earnings and profits in the case of distributions to a 20-percent or more corporate shareholder to include adjustments for accelerated depreciation. The committee intends that this provision (former sec. 301(f)) will henceforward apply only where the distribution is between corporations not filing a consolidated return.

In making these modifications to the consolidated return provisions, the committee does not intend to disturb the principle of present law that a sale of corporation's stock generally has no tax effect at the corporate level. On the other hand, the committee believes that it is inconsistent with the present structure of the Code to permit any special basis adjustment, either to the corporation whose stock is sold or to the purchaser, to reflect gain recognized by the seller (whether or not the seller is a corporation). Although a potential exists for multiple corporate-level taxation of the gain on the acquired subsidiary's assets, an appropriate mechanism for avoiding this is provided under section 338.

Effective Date

The amendment to the rules relating to adjustments in the stock in a consolidated subsidiary applies to stock disposed of after October 15, 1987. The computation of gain or loss on such dispositions will thus be computed taking into account the principles of the amendment during the entire period the subsidiary filed a consolidated return with the selling corporation.

The amendment to section 301(e) (formerly sec. 301(f)) generally applies to distribution after October 15, 1987. For purposes of determining the earnings and profits after that date, the amendment is deemed to have been in effect for all prior periods, whether before, on, or after the date. However, the amendment does not affect the determination whether any distribution on or before October 16, 1987, was a dividend, or the amount of any reduction in accumulated earnings and profits on account of any such distribution.

2. Limitation on Consolidated Return Pass-Through (sec. 6522 of the bill and sec. 1503 of the Code)

Present Law

Under present law, corporations may file consolidated tax returns if they are members of an affiliated group of corporations. In general, a parent and a subsidiary corporation are members of an affiliated group for this purpose if the parent corporation owns stock of the subsidiary possessing at least 80 percent of the total voting power and value of all the subsidiary stock, excluding certain nonvoting preferred stock (secs. 1501 and 1504 of the Code).

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[4] In mandating these modifications to the rules for determining earnings and profits for investment adjustment purposes, the committee does not intend to affect the authority of the Treasury Department to require in the consolidated regulations that earnings and profits (computed under the general rules of section 312) be deemed distributed up the entire chain of affiliated corporations to the common parent on an annual basis.

Under the consolidated return regulations, the consolidated tax return of a parent corporation and an affiliated subsidiary generally allows 100 percent of a subsidiary's losses to offset the parent's income, or conversely, allows 100 percent of a subsidiary's income to be offset by the parent's losses, even though the parent may own less than 100 percent of the subsidiary's stock.

The consolidated return regulations generally require the parent corporation to adjust its basis in the subsidiary stock upward for the parent's allocable share of undistributed earnings and profits of the subsidiary, and downward for the parent allocable share of its deficits in earnings and profits (though no downward adjustment for earnings and profits deficits is required with respect to preferred stock owned by the parent).

Reasons for Change

Present law permits the shifting of the benefits of tax attributes between the affiliated group and non-members. As one example, if a parent corporation has losses and a subsidiary has income, nonmembers of the group may own an unlimited amount of non-voting preferred stock in the subsidiary (or a limited amount of common or voting stock), and may shelter the income of the subsidiary attributable to their stock with losses of the parent corporation through the consolidated return.

As another example, if a parent corporation has income and a subsidiary has losses, the parent may utilize the entire amount of the losses to offset its income, even though a non-member may own a portion of the subsidiary stock that is effectively bearing the losses. In addition, if the parent corporation owns preferred stock as well as common stock, it need not reduce the basis of its perferred stock even for losses that effectively reduce the value of the preferred, and thus may be able to generate an artificial loss on a disposition of the preferred stock.

Explanation of Provision

If a member of an affiliated group of corporations owns less than 100 percent of the stock of a subsidiary that is a member of the group, the bill denies consolidation of the percentage of the subsidiary's income or loss allocable to stock owned by nonmembers. All classes of stock are counted for this purpose, including nonvoting preferred stock described in section 1504(a)(4) of the Code.

It is expected that rules will be provided similar to the rules utilized under present law in determining the portion of the earnings and profits (or deficit in earnings and profits) of the subsidiary that is allocable to the parent's stock. The committee expects that these rules will take into account losses that are economically attributable to preferred stock, and that the rules for allocating earnings and profits will be conformed to the rules for allocating income and losses.

Effective Date

The provision is effective for taxable years beginning after December 31, 1987.

3. Denial of Graduated Rates for Personal Service Corporations (sec. 6523 of the bill and sec. 11 of the Code)

Present Law

Under present law, corporations are subject to a tax at the rate of 34 percent. However, for corporations with taxable income below $335,000, graduated rates are provided. These rates are 15 percent on taxable income not over $50,000, and 25 percent on taxable income over $50,000 but not over $75,000, with the benefits of these lower rates phased out as taxable income increases from $100,000 to $335,000.

Reasons for Change

The personal service income of corporations owned by its employees is taxed to the employee-owners at the individual graduated rates as it is paid out as salary. The committee believes that it is inappropriate to allow the retained earnings to be taxed at the lower corporate graduated rates.

Explanation of Provision

The taxable income of a personal service corporation (as defined in section 448(d)(2) relating to the cash method of accounting) will be taxed at a flat rate of 34 percent. For this purpose, a personal service corporation is a corporation substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and substantially all the stock of which is held by the employees performing services for the corporation.

Effective Date

The provision applies to taxable years beginning after December 31, 1987.

4. Liquidations of Corporate Subsidiaries (sec. 6524 of the bill and secs. 332, 337, 355 and 304 of the Code)

Present Law

Gains on certain distributions to a controlling U.S. corporate shareholder (an 80-percent distributee) are not taxed to the distributing corporation in a liquidation (sec. 337). (Gains on liquidating distributions to a controlling foreign corporate shareholder generally are taxed to the distributing corporation (sec. 367(e)).

By contrast, a nonliquidating distribution to a controlling U.S. corporate shareholder causes the distributing corporation to recognize gain, though the gain would be deferred if the two corporations were filing consolidated returns until a disposition of the distributed property or certain other events (sec. 311 of the Code; Treas. Reg. sec. 1502-13).

Certain divisive distributions of corporate stock are also tax-free to the distributing corporation, provided that certain statutory and other constraints are met, including a condition that the transaction not be a device for the distribution of earnings and profits and certain continuity requirements (sec. 355).

A sale of stock of a subsidiary to a related corporation is generally "deemed" to be a dividend to the extent of earnings and profits of the two corporations, and the statute provides specific rules for the movement of earnings and profits and other aspects related to such a dividend. In determining whether two corporations are related for purposes of this rule, certain "back attribution" rules apply with the result that a corporation can be deemed to receive a dividend or other distribution from another corporation in which it owns no stock. This can result in a situation in which otherwise applicable basis-reduction requirements fail to apply. In some instances these rules together produce tax results more favorable than an actual sale or an actual dividend (sec. 304).

A corporation or other shareholder that surrenders stock in exchange for property distributed in a liquidation generally recognizes capital gain or loss, respectively, to the extent that the value of the property received exceeds or is less than the shareholder's basis in its stock of the liquidation corporation. Under a special provision, however, no gain or loss is recognized by the recipient corporation on liquidation of another corporation if the recipient corporation owns 80 percent of the vote and value of the stock of the liquidating corporation (sec. 332). Moreover, foreign shareholders generally are not taxed on the receipt of liquidating distributions.

A distribution received by one corporation from another is a dividend to the extent of the current or accumulated earnings and profits of the distributing corporation and produces recovery of basis or a capital gain to the extent such earnings and profits are exceeded (sec. 301).

If the recipient corporation and the distributing corporation are members of an affiliated group (for example, generally where the recipient corporation owns 80 percent of the vote and value of the distributing corporation's stock) the recipient corporation is eligible for a 100 percent dividends-received deduction if the distribution is out of earnings and profits of a taxable year on each day of which the distributing and recipient corporations were members of the affiliated group, and if an election is made. If the two corporations are filing a consolidated return, the dividend is excluded from income of the recipient.

Reasons for Change

The committee believes that it is inappropriate for corporations to be permitted effectively to dispose of subsidiaries in exchange for cash or other property without the recognition of current corporate level tax on the appreciation in the stock of the subsidiary. The committee does not believe that the potential for an additional corporate level tax in the future, resulting from a carryover basis in the assets of the subsidiary, is the economic equivalent of a current tax on the appreciation at the time of the sale or distribution.

The committee also believes that certain transactions undertaken by taxpayers under present law may provide new owners of a corporation with greater ability to dispose of subsidiaries without corporate level tax than was enjoyed by the old owners of the corporation. One example of such a transaction is the so-called "mirror" subsidiary transaction. This transaction involves a liquidation of an acquired corporation into one or more "mirror" subsidiaries of the acquiror which together have purchased the stock of the target corporation and which have a basis in the hands of the acquiror reflecting the respective values of different subsidiaries, divisions, or other assets of the acquired corporation. The liquidation is claimed to be a nontaxable event to the distributing corporation because the liquidation is claimed to qualify under the parovision excepting liquidating distributions to an 80-percent distributee. However, instead of effectively retaining a carryover basis for the distributed property so that gain is recognized when the property leaves the group, some taxpayers maintain that the "mirror" subsidiary, which has a high, fair market value basis, can be sold outside the group without incurring the corporate level tax that would have been incurred if the acquired corporation itself had sold the assets that were distributed to the mirror subsidiary.

The committee is also aware that some taxpayers take the position that certain other provisions of the Code may permit the creation of structures said to allow the sale or distribution of an appreciated corporate subsidiary without the recognition of current corporate level tax on the appreciation. Such provisions include the provisions of section 304 of the Code and the "deemed" dividend that it creates, and the provisions of section 355 of the Code that, together with section 358 of the Code, permit a substituted basis when stock of one corporation is distributed by another corporation. Such provisions might be used to provide a stepped-up, fair market value basis when a subsidiary of an acquired corporation is distributed to the acquiring corporation. The committee believes that the requirements of section 355 of the Code should generally prevent the use of that section to accomplish a sale of a recently distributed subsidiary without corporate level tax, or effectively to accomplish a sale of a subsidiary to any significant shareholder by a distribution with respect to recently purchased stock. However, the committee believes that it is appropriate to treat section 355 distributions within an affiliated group generally in the same manner as other distributions, to diminish tax-avoidance positions that might be taken by some taxpayers. In addition, the committee believes that certain additional bright-line rules are desirable.

In general, the committee believes it is desirable to conform the rules governing liquidating distributions within a corporate group to the rules governing nonliquidating distributions.

Explanation of Provision

The bill generally treats liquidating distributions to an 80-percent corporate distributee that are not taxed under present law in the same manner as nonliquidating distributions. The distributing corporation recognizes gain as if the property distributed had been sold to the distributee at fair market value. For purposes of the liquidation rule (unlike a nonliquidating distribution) loss is also recognized; however no loss in excess of the gain recognized is permitted. The rule that generally would not permit a loss to be recognized on a liquidating distribution to a related party if the property is not distributed pro-rate to all shareholders does not apply for this purpose.

If the distributing corporation and the recipient corporation are filing consolidated returns, the transaction is treated as a deferred intercompany sale with the result that the gain of the distributing corporation is deferred until the distributed property leaves the group or certain other events under the consolidated return regulations occur. The liquidation of the distributing corporation is not treated as a disposition of the distributing corporation for this purpose. Also, for this purpose, the disposition outside the group of some of the assets distributed in the liquidation will trigger gain recognition with respect to those assets but not with respect to other assets that were distributed in the liquidation and that are retained within the group. The consolidated return regulations shall not apply to any transaction to the extent they are inconsistent with this provision.

In the case of such a distribution to an 80-percent distributee parent corporation that is not filing a consolidated return with the distributing corporation, the parties may elect to defer the current recognition of gain if they agree to recognize gain under rules similar to the rules that apply in the case of consolidation, for example, when the distributed property leaves the affiliated group.

The bill retains the rule of present law that no gain or loss is recognized by an 80-percent controlling corporate shareholder on the liquidation of a subsidiary, but with a modification. To the extent of the distributing corporation's current or accumulated earnings and profits (including earnings and profits generated by the recognition of any non-deferred gain on the distribution), the amounts distributed to the recipient corporation are treated as a dividend. If the dividend is eligible for the 100 percent dividends received deduction or is excluded in consolidation there will be no tax to the recipient. To the extent the dividend is not eligible for such treatment (for example, a dividend out of pre-affiliation earnings and profits or a dividend paid to a foreign shareholder) it will be taxable to the recipient corporation.

Because the bill treats liquidating distributions from a U.S. corporation to a foreign parent as a dividend, the committee intends that similar treatment apply to a foreign corporation that has a U.S. branch engaging in a U.S. trade or business and that liquidates or otherwise terminates its U.S. business. Thus, the committee intends that the branch profits tax be imposed on either of these two events. Accordingly, the committee intends that I.R.S. notice 86-17 (Dec. 12, 1986) will no longer be applicable to liquidation of a foreign corporation with a U.S. business or the termination of a foreign corporation's U.S. business, either of which occur after the effective date of the provision (after October 15, 1987).

The bill provides that a distribution of stock will not qualify for nonrecognition under section 355 of the Code if control of a corporation which was conducting such business was acquired in a taxable transaction within the 5 year period ending on the date of the distribution through one or more corporations, including the distributing corporation.

The bill modifies the provisions of section 304 of the Code in the case of transactions between members of a group controlled by the same corporation (for this purpose, control is determined under section 304 without regard to the back-attribution rules of section 318(a)(3)(C)). In the case of any sale of stock of one member of the group to another member, the transaction is treated as if the stock that is sold had been distributed to the common parent (determined under section 304 without regard to back attribution) and recontributed to the recipient corporation, and as if the cash or other property that is exchanged had likewise been distributed to the common parent and recontributed to the recipient corporation. The bill also provides the Secretary authority to provide regulations making appropriate adjustments to the members' earnings and profits and to the indirect foreign tax credit provisions, including proper adjustments to the earnings pool as well as recognition of the indirect credit.

The bill also expressly provides that Treasury regulatory authority extends so that the purposes of these provisions may not be circumvented by any other transactions. The purposes of these provisions include clarification that a current corporate level tax is to be paid when an appreciated subsidiary or other property is effectively disposed of outside of the group. It is intended that transactions that result in this effect, even though they may take some other form, will result in the payment of the tax.

No inference is intended regarding the treatment of "mirror" subsidiary transactions under present law.

Effective Date

The provisions are effective for distributions after October 15, 1987.

5. Regulated Investment Companies (sec. 6526 of the bill and secs. 851 and 4982 of the Code)

Present Law

In order to avoid a penalty excise tax, regulated investment companies (RICs), commonly called "mutual funds," must distribute before January 1 of any year at least 97 percent of their ordinary income earned during the prior calendar year and 90 percent of their capital gain net income for the twelve month period ending on October 31 of that year.

Dividends from stock owned by a RIC are includible in the RIC's income when received. *See* Rev. Rul. 78-117, 1978-1 C.B. 214.

Reasons for Change

The Committee believes that RICs should distribute as much of their earnings to their shareholders as possible.

The Committee believes that income is more accurately measured if dividends are includible when the right to such dividend is fixed.

Explanation of Provisions

The distribution required to avoid the penalty excise tax would be increased to 98 percent of ordinary income and 91 percent of capital gain net income.

A RIC would include dividends in income on the ex-dividend date for the stock. The ex-dividend rate is the date on which the shareholders entitled to receive the dividends is determined.

Effective Date

The provision increasing the maximum distribution would apply to calendar years beginning after December 31, 1986. The provision including dividends in income on the ex-dividend date would be effective for ex-dividend dates after December 31, 1986.

D. Partnership Provisions

1. Treatment of Publicly Traded Partnerships Under the Passive Loss Rule (sec. 6531 of the bill and sec. 469 of the Code)

Present Law

Under present law, deductions from passive trade or business activities (within the meaning of the passive loss rule (sec. 469)), to the extent they exceed income from such passive activities, generally may not be deducted against other income. Similarly, credits from passive activities generally are limited to the tax attributable to the passive activities. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity.

Income from passive activities does not include income such as compensation for services or portfolio income (including interest, dividends, royalties, annuities, and gains from the sale of property held for investment). For this purpose, property held for investment generally does not include an interest in a passive activity.

A passive activity generally is an activity involving the conduct of a trade or business in which the taxpayer does not materially participate. Present law provides that, except as provided in regulations, no interest in a limited partnership as a limited partner is treated as an interest with respect to which the taxpayer materially participates. Present law also provides Treasury regulatory authority to issue regulations requiring net income or gain from a limited partnership to be treated as not from a passive activity. Thus, except to the extent that the Treasury Department may provide in regulations, income from limited partnerships, including publicly traded limited partnerships, may be offset by passive losses from other sources.

Reasons for Change

It is possible that, absent regulations, taxpayers may take the position that income from such partnerships is treated as passive income under the passive loss rule. The committee is concerned that such a result contravenes the purpose of the passive loss rule to curb the expansion of tax shelters and to restore fairness and equity to the tax system. The passive loss rule was enacted with the view that the availability of tax benefits that may not represent real economic losses to shelter positive sources of income harmed the economy generally, by retarding the growth of sectors of the economy with the greatest potential for expansion.

In this regard, the committee believes that the return on investment in a publicly traded partnership is essentially comparable to the return on other portfolio investments. Under the passive loss rule, passive losses cannot be applied to offset portfolio income such as interest, dividends, annuities or royalties not derived in the ordinary course of a trade or business. The committee believes that income from all publicly traded partnerships should be treated similarly to income from such investments for purposes of the passive loss rule.

Thus, the bill provides that net income from an interest in any publicly traded partnership is not treated as passive income that can be offset by passive losses. Rather, like dividend income and other portfolio income, income from publicly traded partnership interests is not allowed to be offset by losses (or credits) from passive activities. Losses (and credits) from interests in such partnerships are suspended at the partner level and allowed upon a disposition of the interest in the partnership.

Explanation of Provision

Under the bill, net income from publicly traded partnerships is not treated as passive income for purposes of the passive loss rule. Each partner in a publicly traded partnership treats loss (if any) from the partnership as separate from income and loss from any other publicly traded partnership, and also as separate from any income or loss from passive activities. Net income from publicly traded partnerships is treated as portfolio income under the passive loss rule.

Net losses and credits attributable to the interest in the publicly traded partnership are not allowed against the partner's other income, but rather are suspended and carried forward. Such net losses can be applied against net income from the partnership in the next year (or the next succeeding year in which the holder of an interest in the partnership has net income from the partnership). Upon a complete disposition (within the meaning of the passive loss rule) of the partner's entire interest in the publicly traded partnership, any remaining suspended losses are allowed.

In general, income and loss items attributable to an interest in a publicly traded partnership can offset each other. Thus, for example, assume that a holder of an interest in a publicly traded partnership has a net loss from the partnership in one year of $2,000, and net income from the partnership in the next year of $1,500. $2,000 of the loss from the first year may be applied against the $1,500 income in the second year. The remaining $500 loss continues to be suspended at the partner level, and may be carried forward to future years to offset net income from the partnership. Similarly, a partner's share of credits from the partnership may be applied only to offset the partner's income tax liability attributable to the partnership interest. The election to adjust basis in the event of a disallowed credit upon a complete disposition is intended to apply, in the case of a complete disposition of an interest in a publicly traded partnership.

In the case of publicly traded partnerships with income that is treated as portfolio income (under the passive loss rule as generally applicable) and losses from business activities, the losses may not be applied against the portfolio income. Thus, under the bill, partners' shares of the loss may not be applied against their shares of that portfolio income. Thus, partners in publicly traded partnerships cannot offset losses from partnership activities against portfolio income within the partnership that could not be offset against portfolio income derived outside the publicly traded partnership.

In determining which losses from the partnership interest are suspended and carried forward under the provision, the general rules normally applicable in determining which losses are suspended under the passive loss rule are applicable. Generally, the amount of the suspended losses is determined on a pro rata basis.

For purposes of this rule, partners in publicly traded partnerships treat their interests in each such partnership as separately subject to the loss (and credit) limitation and disposition rules of the passive loss rule. Thus, under this rule, no net losses or credits attributable to an interest in a publicly traded partnership are allowed against income other than income from that partnership (absent a complete disposition of the partner's interest in the partnership).

The rules applicable to transfers by reason of death and to gifts are also intended to apply, in the case of transfers of interests in publicly traded partnerships. This is consonant with the intention of the committee in applying the loss and credit limitations and the disposition rules of the passive loss rule separately at the partner level to partners' items from publicly traded partnerships.

The intended overall result is that net losses and credits of a partner from each publicly traded partnership be suspended at the partner level, carried forward (not back) and netted against income, other than the partnership's portfolio income, from (or tax liability attributable to) that publicly traded partnership, and that suspended losses are allowed upon a complete disposition of the partner's interest in the partnership.

Publicly traded partnerships

Publicly traded partnerships are defined for purposes of the provision as partnerships whose interests are (1) traded on an established securities market, or (2) readily tradeable in a secondary market (or the substantial equivalent thereof).

For this purpose, an established securities market includes any national securities exchange registered under the Securities Exchange Act of 1934 or exempted from registration because of the limited volume of transactions, and any local exchange. It also includes any over the counter market. An over the counter market is characterized by an interdealer quotation system which regularly disseminates quotations of obligations by identified brokers or dealers, by electronic means or otherwise.

An interest is treated as readily tradeable on a secondary market (or the substantial equivalent thereof) if the interest is regularly quoted by brokers or dealers making a market in the interest. (See Treas. Reg. section 1.453-3(d)(5).) Thus, for example, an interest is really tradeable in a secondary market where the interest is traded on a market essentially equivalent to an over the counter market, or where the holder has a readily available, regular and ongoing opportunity to sell or exchange his interest.

A partner's ability to trade the interest, without more, will not cause the interest to be treated as readily tradeable, nor will occasional sales of interests in the partnership, the terms of which are not widely publicized or widely available, indicate the existence of a secondary market.

The existence of a buy-sell agreement among the partners, without more, will not cause a partnership to be treated as publicly traded. Nor will the occasional and irregular repurchase or redemption by the partnership, or acquisition by the general partner, of interests in the partnership, cause the partnership to be considered as publicly traded under the provision. A regular plan of redemptions or repurchases, or similar acquisitions of interests in the partnership such that holders of interests have readily available opportunities to dispose of their interests, that is essentially equivalent to a secondary market, indicates that the interests are readily tradeable on what is the substantial equivalent of a secondary market.

In general, a provision for the discretion of the general partner or the partnership to refuse consent to transfer of an interest in the partnership (or of rights to income or other attributes of an interest in the partnership) does not, without more, prevent a partnership from being considered publicly traded. For example, the discretion of the general partner to refuse consent to a transfer if the transfer would cause a termination of the partnership for Federal income tax purposes does not cause the partnership to be treated as not publicly traded. Similarly, if the general partner must consent to any transfer of an interest in the partnership, but the assignment of rights to income (or other attributes) of the partnership is not so limited, the consent requirement does not cause the partnership to be considered as not publicly traded.

Effective Date

The provision is effective as if included in the amendments made by section 501 of the Tax Reform Act of 1986. Thus, the provision is effective for taxable years beginning after December 31, 1986.

2. Study of Tax Treatment of Publicly Traded Partnerships (sec. 6531(c) of the bill)

Present Law

Present law provides that a partnership is not subject to tax at the partnership level, but rather, income and loss of the partnership is subject to tax at the partner's level. A partner's share of partnership income is generally determined without regard to whether he receives any corresponding cash distributions. Thus, under present law, partnerships generally are treated as conduits for tax purposes.

Reasons for Change

The committee, in this bill, has taken action to change the tax treatment of certain publicly traded partnerships, based on its concerns related to preserving the effectiveness of the passive loss rule to curb tax shelters, achieving fair and equitable tax rules, and improving administrability of the tax law. The committee feels that it is appropriate to monitor and observe the changes made, in order to ascertain whether they have been effective and whether further changes are necessary.

Explanation of Provision

The bill provides that the Secretary of the Treasury or his delegate shall conduct a study of compliance and administrative issues relating to the tax treatment of publicly traded partnerships and other large partnerships.

Effective Date

The Secretary is required to submit a report on the study, with such recommendations as the Secretary deems appropriate, to the House Committee on Ways and Means and the Senate Committee on Finance no later than January 1, 1989.

E. Foreign: Exemption for Eurobond Interest Paid Through the Netherlands Antilles (sec. 6541 of the bill)

Present Law

In the summer of 1987, the Treasury Department terminated the tax treaty between the United States and the Netherlands Antilles, except for the provisions limiting the taxation of interest. The provisions that remain in force generally exempt interest paid by U.S. persons to Antilles persons.

Reasons for Change

The committee believes that it is important that U.S. businesses have access to the Eurobond market as a source of capital. Before the exemption from tax of portfolio interest paid to foreign investors in the 1984 Act, U.S. corporations seeking access to the Eurobond market generally established international finance subsidiaries to issue Eurobonds, almost all of which were incorporated in the Netherlands Antilles. With the goal of insuring stability in the Eurobond market, the committee believes that it would be appropriate to adopt a Treasury Department proposal providing statutory exemption for certain interest paid to Netherlands Antilles entities that is used to support the payment of interest on certain Eurobonds.

Explanation of Provision

The bill provides a statutory exemption from U.S. withholding tax for qualifying interest received by certain controlled foreign corporations incorporated in the Netherlands Antilles (Netherlands Antilles CFCs). In addition, this interest generally will not be treated as effectively connected with the conduct of a trade or business in the United States if the Netherlands Antilles CFC is not engaged in the conduct of a trade or business in the United States through a permanent establishment (as defined under the terms of the U.S.-Netherlands tax treaty, as extended to the Netherland Antilles, as in effect on June 30, 1987) at the time the interest is paid or accrued.

The bill does not exempt any interest from the U.S. withholding tax on interest or the U.S. net tax on interest unless that interest would be exempt under the terms of the Antilles Treaty as in effect on June 30, 1987. Thus, a Netherlands Antilles CFC would not benefit from the interest exemptions of the bill if it obtained certain special tax benefits described in Article I of the Protocol applicable to the extension of the U.S.-Netherlands treaty to the Netherlands Antilles, effective September 28, 1964, which denies the benefit of the treaty's interest article to entitles that obtain those special tax benefits.

The bill defines qualifying interest to mean interest (including original issue discount) which would otherwise be subject to withholding tax or net basis tax (before application of the Antilles treaty) and which is received by a Netherlands Antilles CFC on a U.S. affiliate obligation. The amount of U.S. affiliate obligations which may be taken into account at any time cannot exceed twice the principal amount (as of that time) of outstanding pre-October 15, 1984, obligations of the Netherlands Antilles CFC. In the case of an obligation with original issue discount, the principal amount as of any day is equal to its revised issue price as of that day.

The bill defines U.S. affiliate obligation as any obligation of, and payable by, a U.S. person who is an affiliate of the Netherlands Antilles CFC. The bill defines the term "Netherlands Antilles CFC" as any controlled foreign corporation which was in existence and incorporated in the Netherland Antilles at all times between October 15, 1984, and the date of the interest payment; which meets requirements based on the principles set forth in Revenue Rulings 69-501, 69-377, 70-645, and 73-110, as applied in Revenue Ruling 86-6; and the principal purpose of which on October 15, 1984, consisted of the issuing of obligations meeting the requirements of clauses (i) and (ii) of Code section 163(f)(2)(B), if applicable (or short-term borrowing from persons other than affiliates), and lending the proceeds of such obligations (or the proceeds of such borrowing) to affiliates.

The bill grants to the Secretary authority to treat as a Netherlands Antilles CFC certain non-U.S.-owned Antilles companies. The committee intends that the Secretary exercise this authority only to provide stability to the Eurobond market. In this regard, the committee generally anticipates that the Secretary will use this authority to exempt from U.S. tax interest paid to non-U.S.-owned entities that are financing affiliates of non-U.S. active business corporations and whose principal purpose is raising funds through public debt offerings in the Eurobond market (or the short-term Eurodollar market) and lending those funds to affiliates.

The bill defines pre-October 15, 1984, obligation as any obligation of, and payable by, the Netherlands Antilles CFC if that obligation was issued before October 15, 1984 or was issued on or after that date pursuant to a written binding agreement entered into before October 15, 1984, or the exercise of a warrant or the conversion of a convertible obligation if such warrant or convertible obligation was issued before October 15, 1984, and, in the case of an obligation issued after December 31, 1982, certain compliance requirements added by the Tax Equity and Fiscal Responsibility Act of 1982 are met with respect to such obligation.

The committee intends that the legislative history of sections 127(g)(3) and 121(b)(2) of the Deficit Reduction Act of 1984, relating to grandfather protection for certain U.S.-affiliate obligations, be treated as applicable to the interpretation of this provision, to the extent relevant.

Effective Date

The provision is effective for interest paid or accrued after the date of enactment.

F. Pensions: Modify Full Funding Limitation (sec. 6551 of the bill and sec. 412 of the Code)

Present Law

Under present law, subject to certain limitations, an employer may make deductible contributions to a qualified defined benefit pension plan up to the full funding limitation (sec. 404). The full funding limitation generally is defined as the excess, if any, of (1) the accrued liability (including normal cost) under the plan, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the value of the plan's assets determined under section 412(c)(2) (sec. 412(c)(7)). Generally, the accrued liability is based on projected benefits, which, unlike accrued benefits, are the benefits that are projected to be earned by normal retirement age, rather than the benefit accrued as of the close of the current year.

If a defined benefit plan is terminated, the employer's liability to plan participants does not exceed the plan's termination liability (generally the liability for benefits determined as of the date of the plan termination). However, contributions to a plan with assets significantly in excess of termination liability may be deductible because the full funding limitation is determined on the basis of projected benefits.

Reasons for Change

The committee believes that defined benefit pension plans should be funded in such a manner as to provide benefit security for participants. The committee does not believe, however, that an employer should be entitled to make excessive contributions to a defined benefit pension plan to fund liabilities that it has not yet incurred. Such use of a defined benefit plan is equivalent to a tax-free savings account for future liabilities and is inconsistent generally with the treatment of unaccrued liabilities under the Code.

The committee believes that an overall cap on an employer's deductions for plan contributions is appropriate in the case of overfunded plans and that the proper balance between the competing concerns described above is achieved by precluding deductible contributions to a defined benefit pension plan to the extent that the contributions cause plan assets to exceed 150 percent of current liabilities (i.e., generally accrued liabilities).

Explanation of Provision

Under the bill, the full funding limitation generally is defined to mean the excess, if any, of (1) the lesser of (a) the accrued liability (including normal cost) under the plan, or (b) 150 percent of current liabilities (as defined for purposes of the funding rules in this bill, except that pre-participation years of service are taken into account in all cases), over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the value of the plan's assets determined under section 412(c)(2).

The bill does not modify the definition of accrued liability in section 412(c)(7). Also, the requirement of section 412(c)(6)(B) that all amortizable amounts be considered fully amortized is applied without regard to the change in the full funding limitation (adding the 150 percent of current liability limitation).

The committee further intends that the full funding limitation (as well as the other limitations on deductions for plan contributions) may not be avoided by the creation of multiple plans with coordination of benefits between the plans. The Secretary is to prescribe rules consistent with this intent.

Effective Date

The provision is effective for years beginning after December 31, 1987.

G. Estate and Taxes

1. Freeze of 1987 Rates (sec. 6561 of the bill and sec. 2001 of the Code)

Present Law

The estate and gift taxes are unified, so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The generation-skipping transfer tax is computed by reference to the maximum Federal estate tax rate.

For 1987, the gift and estate tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent on taxable transfers over $3 million. For transfers occurring after 1987, the maximum gift and estate tax rate is scheduled to decline to 50 percent for taxable transfers over $2.5 million.

Reasons for Change

The Committee does not believe it is appropriate to permit revenue from existing taxes to be reduced at a time when additional revenues are needed to reduce the budget deficit.

Explanation of Provision

The gift and estate tax rates applicable in 1987 are made permanent.

Effective Date

The provision is effective for transfers occurring after December 31, 1987.

H. Excise Taxes

1. Telephone Excise Tax: 3-Year Extension (sec. 6571 of the bill and sec. 4251 of the Code)

Present Law

A 3-percent excise tax is imposed on amounts paid for local telephone service, toll (long-distance) telephone service, and teletypewriter exchange service (Code sec. 4251). The tax is scheduled to expire after December 31, 1987.

Exemptions from the tax are provided for communications service furnished to news services (except local telephone service to news services), international organizations, the American National Red Cross, servicemen in combat zones, nonprofit hospitals and educational organizations, State and local governments, and for toll telephone service paid by a common carrier, telephone or telegraph company, or radio broadcasting company in the conduct of its business. Exemptions are also provided for installation charges, certain coin-operated service, and private communications systems (e.g., certain dedicated lines leased to a single business user).

Reasons for Change

The committee does not believe it is appropriate to permit existing taxes to expire at a time when additional revenues are needed to reduce the budget deficit. Therefore, the committee determined that a 3-year extension of the telephone excise tax is appropriate in view of the existing budgetary deficit situation.

Explanation of Provision

The bill extends the current 3-percent telephone excise tax for 3 years, through December 31, 1990.

Effective Date

The provision is effective for telephone bills rendered after December 31, 1987, and before January 1, 1991.

2. Collection of Diesel Fuel and Certain Other Motor Fuels Taxes on Sales to Retailers (sec. 6572 of the bill and sec. 4041, 4101, 6421, and 6427 of the Code)

Present Law

The diesel fuel and special motor fuels excise taxes generally are imposed on the sale of the taxable fuel by a retail dealer to the ultimate consumer of the fuel. Under an exception, retail dealers may elect to have wholesale distributors collect and pay the diesel fuel tax when the fuel is sold to the retailer.

Reasons for Change

The committee has learned that imposition of the tax at the retail level where there are many tax collectors at the end of a long marketing chain has fostered inefficient collection procedures and encouraged development of tax avoidance schemes. Imposing these taxes at an earlier stage in the marketing of these fuels would reduce opportunities for evading payment of the fuels taxes. Collection of excise taxes at the point in the distribution chain with a smaller number of taxpayers provides for more efficient administration of the tax since there are fewer taxpayers for the Internal Revenue Service to monitor. Furthermore, collecting these excise taxes at a uniform marketing level eliminates any special advantage for a single industry segment, e.g., integrated operations versus independent wholesale dealers.

Explanation of Provision

Collection of the diesel fuel excise tax on sales by wholesale dealers is made mandatory for all sales. The special motor fuels and aviation fuels (other than gasoline) excise tax likewise is imposed on sale of the fuel by a wholesale distributor.

The provisions of present law permitting tax-free sales for certain exempt purposes are repealed. Further, Treasury is authorized to require information reporting and registration from such persons in the distribution chain of these fuels as it deems necessary to prevent evasion of the tax. Treasury also is authorized to require such bonding of persons who remit these taxes as is necessary to prevent evasion of the tax.

Effective Date

The provision is effective on January 1, 1988.

I. Employment Taxes

1. Elimination of Wage Cap on Medicare Payroll Tax (Sec. 6581 of the bill)

Present Law

The Federal Insurance Contributions Act (FICA) and the Self-Employment Contributions Act (SECA) impose taxes on earned income which are used to fund the Social Security Act programs of Old-Age, Survivors, and Disability Insurance (OASDI) and Hospital Insurance (Part A of Medicare). The Hospital Insurance portion of the tax is set at a rate of 2.9 percent. In the case of employees this is divided evenly between employees and employers at a rate of 1.45 percent each. For purposes of both the Medicare tax and the OASDI tax, present law limits the amount of earnings to which the tax is applied. In 1987, these taxes apply to the first $43,000 of earnings of each employee or self-employed person. This limitation on the amount of earnings subject to the tax is indexed to rise in proportion to increases in average wages. Under the intermediate assumptions in the most recent report of the Trustees of the program, the limit on earnings subject to tax is projected to rise to $45,300 in 1988.

Reasons for Change

The Hospital Insurance Program is part of the overall social security system which provides basic economic security for the aged and disabled. It operates on a basis in which those currently employed pay taxes which support the benefits for those who are retired or disabled. At the same time, those who are paying into the program are establishing the necessary credits to assure their eligibility for benefits when they retire or become disabled. Because of this relationship between current tax liability and future eligibility, Congress has always considered it important to fund these social security programs on a long-range basis which takes into account the projected income and liabilities of the program for many years into the future. According to the intermediate projections in the April 1987 report of the Hospital Insurance Board of Trustees, the Hospital Insurance Trust Fund is out of balance over the next 25 years by 0.44 percent of taxable payroll (the equivalent in 1987 dollar of about $8 billion per year). While income currently exceeds outgo in the short term, this situation is projected to be reversed by 1995 with the fund reaching exhaustion about 7 years thereafter.

In the period after the turn of the century, the projected financial status of the Hospital Insurance program becomes even more unfavorable as the demographic situation worsens. Current actuarial projections indicate that the Hospital Insurance program would need additional funding in the range of $50 billion per year (in

1987 dollars) during the 25-year period from 2012 to 2036 to meet its obligations under existing laws, and the situation becomes still worse after 2036. While these long range projections necessarily lack precision, the magnitude and direction of the future financing problem clearly demands prompt attention. While some of this problem may be susceptible to amelioration through cost constraint, there can be little question that significant additional funding will also be needed.

Providing additional funding through payroll tax rate increases tends to magnify the already regressive nature of the Hospital Insurance tax. While the OASDI tax also is regressive in nature, the overall OASDI system is not regressive because social security benefits are computed under a weighted benefit formula which is progressive in nature. In addition, the partial exemption of social security benefits from income taxation tends to strengthen the overall progressivity of the benefit system. In the case of the Medicare program, however, the benefit structure has no comparable progressivity to offset the regressive nature of the tax. The same benefit protection is provided to low-income wage earners who pay the Medicare tax as is provided to higher income individuals who may have a substantial portion of their earnings exempt from that tax. Under the current system, a worker earning twice the wage base pays 0.75 percent of earning in Medicare taxes, while a worker at or below the wage base pays 1.45 percent.

Providing a removal of the earnings cap on Medicare taxes will make the Medicare tax system flat rather than regressive. Earners at all levels will pay the same percentage of their income into the program and, as under present law, will receive the same benefit coverage.

Explanation of Provision

The Committee provision would eliminate the limit on the amount of earnigns subject to the hospital Insurance tax. Preliminary estimates indicate that the Committee provision would greatly narrow but not completely eliminate the deficit of the trust fund over the next 25 years. This provision would have an impact only to the extent that an individual's own earnings exceeded that limit which is projected to be approximately $45,300 next year. It applies only to the 2.9 percent (1.45 employer and employee each) tax which is dedicated to the Hospital Insurance Trust Fund. The regular social security tax which funds the OASDI program would continue to apply to earnings only up to the present law earnings limit.

Effective Date

Effective for wages paid after, and for self-employment income for taxable years beginning after, December 31, 1987.

2. Increase in Railroad Retirement Tax; Commission on Railroad Retirement Reform (secs. 6582-6585 of the bill)

Present Law

The Railroad Retirement Program consists of a tier I benefit structure which is generally equivalent in benefits and financing to the social security program and a separately financed tier II benefit structure. Under present law, the tier II program is financed primarily by a payroll tax of 14.75 percent for employers and 4.25 percent for employees. This tax is applied to wages up to $32,700 per year. (This limitation on the amount of wages is increased annually by the increase in average annual wages in the general economy.)

Tier II benefits are includible in income for income tax purposes in the same manner as benefits received under a qualified pension plan. However, the 1983 amendments to the Railroad Retirement Program appropriate from the general fund to the Railroad Retirement Account an amount equal to the increase in income tax liability that results from including tier II benefits in income. This appropriation to the Railroad Retirement Account is limited to an aggregate total of $887 million and applies only to benefits received prior to October 1, 1988.

Reason for Change

The 1983 amendments to the Railroad Retirement Program require an annual report on the solvency of the program. The 1987 report includes an analysis by the chief actuary of the program indicating that program is inadequately funded and recommending changes to address the situation. The chief actuary also recommends the establishment of a board to study whether fundamental changes in method of paying for the program need to be considered by the Congress.

Explanation of Provisions

Increase in Railroad Retirement Tax

The committee provision would increase the employer tier II tax by 1.35 percentage points to 16.1 percent. The employee rate would be increased by 0.65 percentage points to 4.9 percent. This overall 2 percentage point increase in the tier II tax would be effective January 1, 1988.

Commission on Railroad Retirement Reform

The committee provision would also establish an 8-member Commission to study alternative methods of securing the long-range solvency of the Railroad Retirement Program. The President would appoint four members, representing railroad management, railroad labor, commuter railroads, and the general public. The President pro tempore of the Senate would appoint two members after consultation with the Chairmen of the Senate Committees on Finance and on Labor and Human Resources. The Speaker of the House of Representatives would appoint two members after consultation with the Chairmen of the Committees on Ways and Means and on

Energy and Commerce. The Commission would submit its findings to Congress by October 1, 1989.

The provision would also eliminate the $877 million limit on the amount of general funds that are appropriated to the Railroad Retirement Account on the basis of income taxes on tier II benefits and would provide that such appropriations will be made for two additional years based on tier II benefits paid through September 30, 1990.

Effective Date

Enactment (tax rate increases effective for wages paid after December 31, 1987).

3. FUTA Fox: 3-year Extension of Repayment Tax; Transfer of Funds into the Federal Unemployment Accounts (secs. 6586-6587 of the bill)

Present Law

The Federal Unemployments Tax Act (FUTA) generates revenues which are allocated among several accounts in the Federal Unemployment Trust Fund. Funds in the Employment Service Administration Account are used to meet the Federal and State administrative costs of operating unemployment compensation programs and most of the cost of Employment Service operations. The Extended Unemployment Compensation Account (EUCA) is used to meet half the cost of extended unemployment benefits (EB), which are paid in times of unusually high unemployment. (The other half of EB costs are funded from State unemployment taxes.) The Federal Unemployment Account (FUA) is a reserve account from which States may borrow funds in the event the State unemployment account is temporarily unable to meet benefit liabilities. Each of these accounts in the Trust Fund has a statutory ceiling. When the ceiling is reached, excess funds are distributed among the account according to rules specified in Title IX of the Social Security Act. When all of these accounts reach their ceiling levels, any excess amounts would be distributed to the State unemployment accounts in the Trust Fund.

The gross Federal unemployment tax rate is 6.0 percent plus a temporary 0.2 percent which was enacted in 1976. In general, employers qualify for a credit of 5.4 percentage points against this tax, leaving a net Federal tax of 0.6 percent plus the temporary 0.2 percent. The tax is paid by employers on the first $7000 of annual earnings of each employee. (In some States the 5.4 percent credit is reduced to recover outstanding State loans from FUA.)

The temporary 0.2 percent additional tax was added in order to repay borrowing of the Federal Unemployment Trust Fund from the general fund of the Treasury during the mid 1970's. The outstanding indebtedness was repaid this year, and the additional tax will terminate at the end of 1987.

Reason for Change

While the EUCA account has fully repaid the outstanding borrowing from the general fund of the Treasury, the experience of the 1970's indicates that the Unemployment Fund may need to accumulate a higher level of reserves than present law provides for in order to have reasonable assurance of weathering economic cycles without undue reliance on general fund borrowing.

Explanation of Provision

The temporary 0.2 percent additional FUTA tax would be continued for three additional years, through 1990. The statutory ceilings on the EUCA and FUA accounts would be increased in order to accommodate the additional revenue generated by extending the tax. The EUCA account ceiling would be increased from ⅛ of the amount of total annual wages to ⅜ of total annual wages. The FUA account ceiling would be increased from ⅛ of total annual wages to ⅝ of total annual wages.

Effective Date

Wages paid during calendar years 1988–90.

J. User Fees

1. Internal Revenue Service (sec. 6591 of the bill)

Present Law

The Internal Revenue Service (IRS) currently provides written responses to questions of individuals, corporations, and organizations relating to their tax status or the effects of particular transactions for tax purposes. The IRS responds to these inquiries through the issuance of letter rulings, determination letters, and opinion letters.

A letter ruling is a written statement issued by the National Office of the IRS that interprets and applies the tax law to a specific set of facts. A letter ruling generally is followed by the IRS on audit in determining the tax liability of the recipient of the ruling.

A determination letter is a written statement issued by a district director of the IRS that applies principles previously announced by the National Office of the IRS to a specific set of facts. A determination letter generally is issued in the same circumstances as a letter ruling and is followed by the IRS on audit in determining the tax liability of the recipient of the letter. Most determination letters involve the qualification of retirement plans and the status of organizations seeking exemption from tax.

An opinion letter is a written statement issued by the National Office of the IRS that addresses the acceptability of the form of a master or prototype pension plan and any related trust or custodial account.

The IRS currently does not charge taxpayers for issuing letter rulings, determination letters, or opinion letters.

Reasons for Change

The committee believes that, as the Administration has proposed in the last several budgets, the relatively small number of persons that request letter rulings, determination letters, and opinion letters should pay for the benefit of these services. The committee also believes that the provision should not be made permanent at this time so that the committee may examine the impact of the provision on taxpayer compliance.

Explanation of Provision

The bill requires the IRS to charge a fee for each request for a letter ruling, determination letter, opinion letter, or other similar ruling or determination. The amount of the fee is to vary based on the type of request, as follows:

Category	*Fee*
Employee plan ruling	$400
Exempt organization ruling	320
Employee plan determination	250
Exempt organization determination	200
Chief Counsel ruling	200

The IRS is authorized to vary the amount of the fee charged for any request based on the average time for (and the difficulty of) complying with the request. In addition, the IRS is authorized to provide exemptions and reduced fees. The IRS may vary the amount of the fee or provide exemptions or reduced fees only if the average fee charged during a fiscal year for requests in any category is approximately the same as the fee listed above for that category.

The amount of the fee is payable in advance and is refundable only if the IRS refuses to respond to the request. The fee is not refundable if the person making the request withdraws the request prior to the issuance of the ruling or determination.

Effective Date

The provision applies to requests filed on or after the first day of the second calendar month that begins after the date of enactment. The provision does not apply to requests filed after September 30, 1990.

2. Extension and Increase in Certain Alcohol, Tobacco, and Firearms Occupational Taxes (sec. 6592 of the bill and secs. 5091, 5111, 5121, 5131, 5271, 5801, and 5845 of the Code)

Present Law

Occupational taxes are imposed on numerous business activities involving the production and marketing of alcohol, tobacco, and firearms products. Brewers currently pay $110 per year for each brewery operated by them, except any brewer of fewer than 500 barrels a year pays $55 per year (sec. 5091). Manufacturers and importers of National Firearms Act (NFA) firearms pay a $500 per year occupational tax for each place of business, except a person who manufactures or imports only weapons classified as "any other weapon" under section 5845(e) pays a tax of $25 per year (sec. 5801). No occupational taxes are imposed on distillers, wineries, or tobacco manufacturers.

Dealers in NFA firearms generally are subject to an annual occupational tax of $200 per place of business; dealers who deal only in weapons classified as "any other weapon" under section 5845(e) are subject to an annual tax of $10 per place of business (sec. 5801).

An annual $255 per place of business occupational tax is imposed on wholesale liquor dealers; an annual $123 tax is imposed on wholesale beer dealers (sec. 5111).

An annual occupational tax of $54 per place of business is imposed on retail liquor dealers; the tax is $24 per place of business for retail beer dealers (sec. 5121). A special tax of $4.50 per month in which sales are made is imposed on "limited retail dealers" in distilled spirits; the tax is $2.20 per month for limited retail dealers in beer and wine only (sec. 5121).

Persons permitted to use distilled spirits without payment of tax, or who deal in or use specially denatured distilled spirits, must obtain permits under present laws, but no occupational tax is imposed on those persons with respect to this activity (sec. 5271).

Present law permits drawbacks (refunds) of the distilled spirits tax in certain cases. Persons receiving drawbacks of this tax for distilled spirits to be used for nonbeverage purposes are subject to an occupational tax based on the amount of alcohol used. The tax ranges from $25 per year (drawbacks not exceeding 25 proof gallons) to $100 per year (drawbacks exceeding 50 proof gallons) (sec. 5131).

Reasons for Change

The Bureau of Alcohol, Tobacco, and Firearms (BATF) incurs significant expenses in regulating the three industries over which it has jurisdiction. The President proposed in his budget that the direct beneficiaries of these regulatory provisions pay a greater share of the costs incurred by BATF.

The committee concurs with the President's proposal. The committee determined that the appropriate way to accomplish the proposal was to increase the present occupational taxes, which generally have not been increased since the early 1950s, and to impose those taxes more uniformly across the businesses affected.

Explanation of Provisions

The present producer/manufacturer occupational taxes are increased to annual amounts of $1,000 per place of business for producers of all taxable alcoholic beverages (distilled spirits, wine, and beer), manufacturers of all taxable tobacco products, and for firearms producers. A special rate of $500 per year applies to businesses having gross receipts of less than $500,000 in the preceding taxable year. For purposes of this special rate, all members of a controlled group of corporations (substituting 50 percent for the general 80 percent test of control) are treated as one business.

The present firearms dealer occupational tax is increased to $500 per year per place of business.

The present alcoholic beverage wholesale dealer occupational taxes are combined and imposed at an increased rate of $500 per year per place of business.

The present alcoholic beverage retail dealer occupational taxes are combined and imposed at an increased rate of $250 per year per place of business. The present occupational taxes on limited retail dealers are repealed. The retail dealer occupational tax further is extended to all persons required to acquire permits for tax-free use of distilled spirits under section 5271.

The three occupational tax rates for persons receiving drawbacks of the distilled spirits tax for spirits used in nonbeverage products are combined and increased to $500 per year per place of business.

Effective Date

These provisions are effective on January 1, 1988.

As under present law, the occupational taxes generally will continue to be paid for a period of 12 months, covering the period July 1–June 30. Thus, subject to special rules for the period January 1–June 30, 1988, all persons subject to tax under the provisions of the bill are liable for the entire annual tax on July 1, 1988.

For the period January 1–July 1, 1988, a series of special rules will apply. Persons initially subject to tax as a result of the provisions are liable for a tax equal to one-half of the otherwise applicable annual rate on January 1, 1988.

In the case of persons who paid an occupational tax during calendar 1987, for which no further tax is due until July 1, 1988, under present law, a tax is due on January 1, 1988, in an amount equal to one-half of the excess of the new tax rate for the occupation involved over the present-law rate.

3. Customs User Fees (sec. 6593 of the bill)

Present Law

As enacted in the Omnibus Budget Reconciliation Act of 1986, an *ad valorem* user fee is applied to all formal entries of merchandise imported for consumption in the amount of 0.22 percent during fiscal year 1987, dropping to the lesser of 0.17 percent or the rate which will provide revenue equal to the appropriated level of custom's commercial operations in fiscal year 1988, and expiring September 30, 1989. The fee does not apply to articles classifiable in schedule 8 of the Tariff Schedules (including products containing U.S. components which are classifiable in item 807.00 of the Schedules and U.S. articles returning to the United States after having been processed abroad which are classifiable in item 806.30)

Reasons for Change

The bill amends the customs user fees provisions in response to concerns expressed by the Administration and the trading community based on experience with the users fees over the past year.

The Administration's budget proposal would have extended the customs users fees indefinitely and modified the schedule 8 exemption insofar as it applies to imported articles containing U.S. components. Athough the committee adopted the Administration's recommendation with respect to the schedule 8 exemption, it chooses to extend the program for one additional year, to September 30, 1989, rather than extending it indefinitely. The committee has a number of concerns about the way the program has been administered thus far and would like to see the concerns addressed satisfactorily before it will consider making this program permanent.

The committee is particularly concerned that the fundamental purpose of the program of providing adequate funding for the commercial operations of the Customs Service is not being met. During the first year of the program, the Office of Management and Budget did not allow any of the proceeds of the customs users fees account to be spent for the commercial operations of the Customs Service. Further, the Administration's budget proposal for the Customs Service for fiscal year 1988 once again called for a drastic reduction of 2,000 customs officers. Such cuts should not be necessary if the customs users fees program is being properly implemented.

The bill also modifies current law dealing with the disposition of user fees and the manner of their application to fund Customs' commercial operations. This modification is designed to clarify current law in order to obviate administrative problems which have arisen from OMB's interpretation of current law. Under its interpretation, OMB has seen fit to maintain two user fees accounts, one for passenger and conveyance fees and another for the commercial operations fee on imports. Because certain legal requirements, such as the procedure for recommending an increase or decrease in user fees, are triggered by the user fee account balance in relation to expenditures, the Committee believes that administration and oversight will be simplified if only a single Customs User Fees Account is established. All users fees are required to be deposited in a single Customs User Fees Account. The bill further clarifies current law by reiterating that funds deposited in the Customs User Fees Account be employed, to the extent provided in appropriations acts, to reimburse all costs of the Customs Service for commercial operations. Finally, the bill includes provisions designed to ensure that operators of foreign trade zones and customs bonded warehouses would no longer be, in effect, assessed twice for customs transactions occurring at such facilities.

Explanation of Provision

The bill amends the customs user fees provisions. First, the expiration date for the fees would be extended for one additional year, until September 30, 1990. Second, in order to avoid placing a double burden on operators of foreign trade zones and customs bonded warehouses, a provision has been added precluding the Customs Service from assessing an annual fee on such operators in addition to the pre-entry fee which is now applicable to merchandise withdrawals from such facilities.

Third, the bill changes provisions of current law which permit importers to avoid the application of the users fees entirely if any portion of the imported article is of U.S. origin and eligible for duty-free treatment under items–806.30 or 807.00 of the Tariff Schedules. As amended, only the value of the U.S. components or materials which are eligible for duty-free treatment under such provisions would be exempt from the users fee. The value of the foreign components of the imported article would be subject to the fee.

To ensure that no additional recordkeeping burdens are imposed upon the public as a result of this amendment, the following simplified accounting requirements applicable to duty-free articles entering or eligible for entry, under items 806.30 and 807.00 of the Tariff Schedules of the United States (TSUS) should be implemented. These requirements would apply to all imports of: (1) articles with U.S. content; (2) commingled merchandise consisting of articles with U.S. content and like or similar articles not containing U.S. content; and (3) articles exported from the United States for processing abroad and returned to the United States for further processing.

Importers may enter the articles on the basis of aggregate data derived from financial and manufacturing reports used by the importer in the normal course of business. The data would be calculated according to generally accepted accounting principles so as to establish the following for a one-year period: (1) the total value of all articles imported, based on U.S. customs principles of valuation; (2) for item 807.00 articles, the U.S. content portion of the value cited in item 1 value represented by processing abroad; and (3) for item 806.30 articles, the portion of the item 1 value represented by processing abroad. In this context, the valuation of all imports during an import year would be based on data from the prior import year and applied across-the-board to such imports, thereby, eliminating discrete calculations with respect to articles, individual entries. Accordingly, 1986 data would apply to 1987 imports, 1987 data to 1988 imports, and so on. It is intended that the term "import year" be defined as either a calendar year or some other 12-month cycle, depending on the accounting cycle utilized by the importer.

Upon termination of operations by an importer, a "catch-up" adjustment reflecting actual percentages from the year prior to the termination would be required to ensure that the importer has paid the appropriate amount of user fee. With the exception of this adjustment, or unless required by a Customs audit, no other adjustment or reconciliation in connection with user fee payments shall be required of the importer.

Fourth, the bill adds clarifying language regarding the customs user fees. In the Budget Reconciliation Act of 1986, Congress required that the fees were to be placed in a dedicated account for expenditures for commercial operations of the Customs Service. The new language specifies that the fees are to be treated as receipts offsetting expenditures of salaries and expenses for commercial operations. The purpose is to make clear that it is inappropriate to treat the fees as revenues, as the Administration has done. In addition, the section clarifies that the user fees on passengers and conveyances are to be deposited in the same dedicated account as the ad valorem fees and, to the extent they are not needed to reimburse the Customs Service for expenses incurred in providing overtime inspectional services, they are to be used as receipts offsetting commercial operations expenditures.

K. Collection of Nontax Debts Owed to Federal Agencies: 3-year Extension (sec. 6601 of the bill, sec. 6402 of the Code, and sec. 3720A of title 31, United States Code)

Present Law

Certain Federal agencies are authorized to notify the IRS that a person owes a past due, legally enforceable debt to the agency. The IRS then must reduce the amount of any tax refund due the person by the amount of the debt and pay that amount to the agency. This program expires after December 31, 1987.

Before a refund can be offset under this program, the agency which is owed a debt must certify to the Treasury that the debtor has been notified about the proposed offset and has been given at least 60 days to present evidence that all or part of the debt it not past due or not legally enforceable. If a refund otherwise due an individual is subject to offset both under this provision and because of AFDC past-due support, the offset for AFDC past-due support is implemented first.

Under IRS regulations, the program only affects refunds due individuals, not corporations.

Reasons for Change

The committee determined that a 3-year extension of the debt collection provisions is appropriate so that the Federal Government can use every means available to collect debts owed to Federal agencies that the agencies have been unable to collect themselves. The committee did not believe it appropriate to permit existing debt collection provisions to expire at a time when additional revenues are needed to reduce the budget deficit. Moreover, expanding the debt collection program to apply to debts owed to all Federal agencies by individuals or corporations should enhance the effectiveness of the program.

The committee was also concerned, however, about the possible negative effect of this program on voluntary tax compliance. The committee therefore provided that the extension would be for 3 years, which would provide the Congress with an additional opportunity to assess the effect of the program on voluntary tax compliance. The committee has also required that the GAO report on the impact of this program on voluntary tax compliance. This report will be an important element in assessing the effectiveness of the program.

Explanation of Provision

The bill extends for three years the tax refund offset program. In addition, the bill expands the scope of the program in two ways. First it applies to debts owed to all (not just selected) Federal agencies. Second, it applies to debts owed by either individuals or corporations.

The committee understands that, prior to the enactment of this bill, some Federal agencies may take actions to notify a debtor of a proposed offset and to certify to the Treasury that a debt is owed, as required by section 3720A of title 31, United States Code. The committee believes that these preliminary agency actions are appropriate and intends that they not be affected by the fact that they were taken before Congress enacted the three-year extension of the Federal debt collection program provided for by this bill.

The committee believes that, prior to the expiration date of December 31, 1990, this provision should be evaluated to determine the extent to which it facilitates the collection of debts owed the Federal Government and increases the amount of debts collected, as well as to examine the effects of this provision on voluntary taxpayer compliance with the income tax law. Therefore, the committee has required that GAO report to the Congress on the effects of this program on voluntary tax compliance. This report is to provide an analyze data on the effects of the program, such as whether taxpayers whose refunds aer offset continue to file tax returns and whether those taxpayers adjust their withholding so as to create additional tax collection difficulties.

Effective Date

The provision is effective on January 1, 1988, and expires after December 31, 1990. The report is due on April 1, 1989.

L. Limitation on Long-Term U.S. Bonds (sec. 6611 of the bill and sec. 3102 of title 31 of the United States Code)

Present Law

The rate of interest that may be paid on a United States bond—defined as an obligation with more than 10 years to maturity when issued—may not exceed 4¼ percent, except that up to $250 billion in bonds with rates of interest above 4¼ percent may be issued to be held by the general public.

When the exception was enacted in 1971, the limitation was set at $10 billion, and it applied to all bonds issued with rates of interest above 4¼ percent. Two years later in 1973, the exception was amended so that it applied only to bonds held by the general public, and bonds held by Federal agencies and the Federal Reserve Banks were not included in the amount subject to the exception.

The amount of the exception has been increased about every two years since it was first enacted, and currently it is $250 billion.

Reasons for Change

The 4¼ percent limitation was enacted in 1918. The first exception was enacted in 1971 to provide relief from a rapidly shortening average maturity of the outstanding debt during a period of several years when interest rates were rising. The average maturity declined from 5 years and 9 months in 1965 to 3 years and 3 months in October 1971 and to 2½ years in 1975. By May 1987, the average maturity had increased to 5 years and 9 months. Nevertheless, in June 1987, the debt held by the general public still was heavily loaded at the short end of the maturity distribution, as one-third of the debt held by the public matures within one year and one-half matures within two years.

Repeal of the interest rate limitation will extend a form of deregulation to the government debt market by allowing the Treasury Department to issue debt in all maturity sectors of the money market. The change will increase the flexibility of the Treasury in the money market and enable it to continue to issue marketable securities maturing in more than 10 years which the market has demonstrated a desire to absorb since the interest rate exception was enacted in 1971.

The committee considered repeal of the interest limitation to be appropriate because the 4¼ percent limitation has become an historical anachronism during the past 15 years as interest rates for most maturities consistently have been higher than the level of the limitation.

Explanation of Provision

The bill repeals the 4¼ percent interest rate limitation on bonds issued to be held by the general public.

Effective Date

The amendment will become effective on the date of enactment.

M. Pension Funding Requirements; PBGC Premiums

1. Minimum funding standard and deductions

a. Additional funding requirements (sec. 6621 of the bill)

Present Law

In general

Under present law, certain defined benefit pension plans are required to meet a minimum funding standard for each plan year. The minimum funding standards require that an employer contribute an annual amount sufficient to fund a portion of participants' projected benefits determined in accordance with one of several prescribed funding methods, using actuarial assumptions that are reasonable in the aggregate.

Generally, a funding method calculates the cost of benefits under the plan in 2 components: (1) normal cost, which represents the cost of benefits allocated to the current year under the plan's funding method, and (2) a portion of the plan's accrued liabilities (i.e., all costs other than normal cost). The costs in (2) include costs with respect to past service liability (e.g, the cost of retroactive benefit increases), experience losses, and changes in actuarial assumptions. The amounts in (2) above are amortized over a period of years depending on the nature of the cost. Experience gains and gains from changes in actuarial assumptions are taken into account generally by offsetting a portion of the gains against the amounts determined under (1) and (2) above for the year. Losses increase such amounts.

Each defined benefit pension plan is required to maintain a special bookkeeping account called a "funding standard account." The account is charged with the costs described above and the amount necessary to amortize waived contributions (see below), and credited with the gains described above, the amount of waived contributions for the year, and contributions for the plan year. If, as of the close of the plan year, the account reflects credits equal to or in excess of charges, the plan is treated as meeting the minimum funding standard for the year. Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the account would exceed credits to the account if no contribution were made to the plan.

Currently, some employers maintain "floor-offset" arrangements, which are combination defined contribution plan and defined benefit plan. Under such an arrangement, a participants' benefits under the defined benefit plan (the floor plan) are offset by the participant's benefits under the defined contribution plan (the offset plan). The IRS has ruled the floor-offset arrangements may meet the qualification requirements of the Code if certain requirements are satisfied.

Past service liabilities

Past service liability existing before the effective date of the minimum funding standards (generally, 1976) is amortized over a period of 40 years. All other past service liability is amortized over a period of 30 years.

Experience gains and losses

Experience losses arise when a plan's experience is less favorable than anticipated under the plan's assumptions (e.g., interest, mortality, morbidity, and employee turnover). Similarly, experience gains arise when a plan's experience is more favorable than anticipated. Experience gains and losses are amortized over 15 years.

Gains and losses from changes in assumptions

If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the liability of a plan is less than the liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the liability, the plan has a loss from changes in actuarial assumptions. The gain or loss for a year from changes in actuarial assumptions is amortized over a period of 30 plan years.

Switchback liability

Certain plans may elect to use an alternative minimum funding standard account for any year in lieu of determining contributions under the rules described above. Specified annual charges and credits apply with respect to the alternative account. The minimum funding standard is considered satisfied for a year if a contribution meeting the requirements of the alternative account is made, even if a greater contribution would be required under the normal funding rules.

If the plan switches back from the alternative account to the regular method of determining contributions, the excess, if any, of charges over credits at the time of the change ("the switchback liability") must be amortized over a period of 5 plan years.

Contingent benefits

Under present law, benefits contingent on events such as the shutdown of a facility are funded in the same manner as other benefits. Thus, the plan assumptions may include a probability that the shutdown or other contingency will occur. If too low a likelihood of the contingency occurring is assumed, then an experience loss occurs when the event occurs.

Shutdown and similar contingent benefits are guaranteed by the Pension Benefit Guaranty Corporation (PBGC) in accordance with the generally applicable rules regarding such guarantees (e.g., the limit on the dollar amount and type of benefit guaranteed) (see discussion below). To the extent the benefits are guaranteed, the guarantee phases in over time after the plan or plan amendment providing for the benefit is adopted (or the effective date of the plan or amendment, if later).

Valuation of assets

Under present law, the value of plan assets is to be determined in accordance with any reasonable actuarial method of valuation that takes into account fair market value and that is permitted under Treasury regulations. The regulations permit plan assets to be valued on the basis of the average value over a period not exceeding the 5 most recent plan years. Regardless of the valuation method used, the method must result in a value that is between 80 percent and 120 percent of fair market value or between 85 percent and 115 percent of average value as defined in the regulations (Treas. reg. sec. 1.412(c)(2)-1(b)(6)).

Factors contributing to underfunding of defined benefit plans

A plan is considered to be underfunded if, upon termination, it lacks sufficient assets to discharge its liabilities. One reason underfunding may arise is that, despite the minimum funding standard, the plan may terminate before the time necessary for full amortization of its liabilities has expired. This is particularly true with respect to plans that base benefits solely on service, rather than on service and salary, and that provide regular benefit increases with respect to all years of service.

For example, assume that, at the time a plan was adopted, it provided benefits measured (in part) by service performed before the plan was adopted. The liability for those benefits (past service liability) is amortized over a period of 30 years. If the plan terminates before the end of the 30-year period, then the plan will be underfunded unless favorable investment experience, gains due to favorable mortality experience or other experience gains are sufficient to offset the unfunded liability arising from the past service benefit.

Underfunding may also be attributable to unamortized losses arising from investment experience or other experience (e.g., mortality, morbidity, employee turnover) that is less favorable than anticipated. An example of significant experience losses creating underfunding is the substantial increase in plan liabilities that is triggered by a plant closing or similar sudden workforce contraction that has not been fully anticipated in funding the plan. In some cases, a plan is underfunded at termination because the employer obtained a waiver of the funding standard and the plan was terminated before the waived funding deficiency was fully amortized.

Reasons for Change

As of September 30, 1985, the PBGC reported a deficit of approximately $1.3 billion. As of September 30, 1986, the PBGC's deficit nearly tripled over the prior year, reaching $3.8 billion (approximately $2 billion of which is attributable to the termination of plans maintained by LTV Corporation). The substantial increase in the deficit of the PBGC is generally attributed to the termination of certain steel industry pension plans with insufficient assets to provide guaranteed benefits.

The PBGC's deficit has not affected its immediate ability to pay pension benefits to retired participants in terminated plans. However, PBGC officials estimate that projected increases in the

PBGC's deficit could result in insufficient assets to pay annual costs in approximately 15 years.

The General Accounting Office issued a report on March 19, 1987 (the "GAO Report")[1] stating that, during the years 1983-85, 70 percent of the claims against the PBGC for termination of underfunded plans resulted because the present-law funding standards do not require sufficient contributions to fund increased unfunded liabilities arising in part from numerous benefit increases within 5 years of plan termination.

The committee believes that the present-law funding requirements expose plan participants and the PBGC to excessive risk. Under present law, the funded status of a plan may deteriorate even if the minimum funding requirements are fully satisfied. Thus, the committee concludes that the present-law rules, which provide long-term financing of increases in unfunded liabilities under a pension plan, create an incentive for employers to provide benefit increase that might otherwise not be affordable.

Accordingly, more rapid funding requirements would more appropriately limit the ability of employers to delay or avoid funding obligations. An employer should not have the opportunity to make pension promises that exceed its financial capacity to meet its promises. In order to reduce the financial risk to plan participants and the PBGC, the bill requires certain plans to be funded more rapidly depending on the funded status of the plan.

The committee believes that certain types of contingent benefits create special funding problems. Benefits contingent on relatively unpredictable events, such as a plant shutdown, typically are not adequately funded before the event occurs. Thus, upon the occurrence of the contingency, a tremendous increase in plan underfunding may occur, and the employer often is not financially able to fund such benefits at that time. In some cases, the liability for the benefits may be shifted to the PBGC. The committee believes that it is appropriate to provide special funding rules with respect to certain contingent benefits, and to coordinate the PBGC guarantee with the funding rules.

Explanation of Provisions

In general

The bill retains the present-law funding standards under section 412 of the Code, with certain modifications. In addition, with respect to an underfunded plan, the minimum required contribution is, in general terms, the greater of (1) the amount determined under section 412 (with the modifications made by the bill), or (2) the sum of (i) normal cost, (ii) the amount necessary to amortize experience gains and losses and gains and losses resulting from changes in actuarial assumptions over 5 years, and (iii) the deficit reduction contribution. In addition, as special funding rule applies with respect to benefits that are contingent on unpredictable events.

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[1] U.S. General Accounting Office, *Pension Plans: Government Insurance Program Threatened By Its Growing Deficit* (GAO/HRD-87-42).

More specifically, the bill provides that, for an underfunded plan, the amount otherwise required to be charged to the funding standard account for a plan year otherwise is increased by (1) the excess of (i) the deficit reduction contribution over (ii) certain charges to the funding standard account reduced by certain credits to such account, plus (2) the unpredictable contingent event amount (if any) for the plan year. The charges taken into account under the preceding sentence include (i) the amount necessary to amortize past service liability, (ii) the amount necessary to amortize each waived funding deficiency, and (iii) the amount necessary to amortize certain amounts credited in the case of an employer previously using the alternative minimum funding standard account (the switchback liability). The credits taken into account include the amounts necessary to amortize decreases in past service liability.

As under present law, contributions in excess of the minimum required contribution will create funding credit balances that may be used to offset the required minimum contribution. In addition, credit balances in existence on the effective date may be used to offset required minimum contributions. The bill does not affect the ability of an employer to maintain a floor-offset arrangement.

Deficit reduction contribution

Under the bill, the deficit reduction contribution is the sum of (1) the unfunded old liability amount, and (2) the unfunded new liability amount. Calculation of these amounts is based upon the plan's "current liability".

Current liability

Under the bill, the term "current liability" means all liabilities to employees and their beneficiaries under the plan (as determined under sec. 401(a)(2)). However, the value of any "unpredictable contingent event benefit" is not taken into account in determining current liability until the event on which the benefit is contingent occurs. An "unpredictable contingent event benefit" is any benefit contingent on an event other than (1) age, service, compensation, death, or disability, or (2) an event which is reasonably and reliably predictable as determined by the Secretary.

The committee does not intend that an event will be considered reliably and reasonably predictable solely because an actuarial probability of the event occurring may be determined. It is further intended that the Secretary of the Treasury will prescribe rules defining events that can and cannot be reasonably and reliably predicted and will revise these rules as new benefits are developed.

Unpredictable contingent event benefits are intended to include benefits that depend contingencies that, like facility shutdowns or reductions or contractions in workforce, are not reliably and reasonably predictable. Such contingencies are not limited to events that are similar to shutdowns or reductions in force. For example, a benefit dependent on the profits of the employer or the value of employer stock dropping below a certain level would be considered a benefit contingent on an event that is not reasonably and reliably predictable (unless the contingency is illusory).

If an employer provides an early retirement window benefit under which employees who have satisfied certain age or service requirements or both are offered a limited period of time during which they may elect to retire, such a window benefit is generally considered to be contingent on an event that can be reasonably and reliably predicted. The Secretary of the Treasury may, in appropriate circumstances, treat such window benefits as benefits which are contingent on an event that cannot be reasonably and reliably predicted.

The committee intends that a benefit contingent on marital status, such as a qualified joint and survivor annuity, is generally to be considered a benefit that is contingent on an event that can be reasonably and reliably predicted.

The committee intends that the Secretary of the Treasury may prescribe rules to prevent employers from avoiding the new minimum funding rules by characterizing contingencies as not reasonably and reliably predictable. For purposes of the definition of current liability, a benefit is generally not to be considered contingent on an event which is not reasonably and reliably predictable if there is substantial certainty that the event on which the benefit depends will occur.

An early retirement subsidy, social security supplement, survivor subsidy or similar benefit in addition to the basic retirement benefit under a plan that is payable only on the satisfaction of certain eligibility conditions (e.g., age and/or years of service eligibility conditions) is included in current liability to the extent that the employee has earned the subsidy, supplement, or similar benefit.

For example, assume that a plan provides that an employee is entitled to a basic retirement benefit commencing at age 65 of 1 percent of final average pay times years of service and that, if the employee retires at age 55 with at least 25 years of service, the employee's retirement benefit will not be actuarially reduced for early commencement (i.e., this is an early retirement subsidy). For purposes of calculating the current liability for such plan for a year, an employee age 50 with 20 years of service has a total retirement benefit (i.e., normal retirement benefit plus early retirement subsidy) of 80 percent of the unreduced age 55 benefit (based on final average pay at age 50). That is, no actuarial reduction for commencement before age 65. The same analysis applies in determining the extent to which a social security supplement, survivor subsidy, or similar benefit has been earned under the plan.

Current liability is generally determined in accordance with plan assumptions. Thus, in the example described above, because not all employees who have earned a right to some portion of the early retirement benefit will ultimately satisfy the eligibility conditions for the subsidy (e.g., not all such employees will remain with the employer until age 55), a plan is to calculate its current liability for the year by using reasonable turnover and mortality factors.

The bill provides a special limitation on the interest rate used for purposes of calculating current liability. Under the bill, the interest rate is required to be within a permissible range, which is defined as a rate of interest that is not more than 20 percent above or below the average mid-term applicable Federal rate (AFR) for the 3-year period ending on the last day before the beginning of the plan year for which the interest rate is being used (or, if shorter, the period that the AFR has been computed). The average is determined by averaging the rate in effect for each month during the applicable 3-year period. If any interest rate used under the plan is not within the permissible range, then the plan is required to establish a new interest rate that is within the permissible range. The Secretary may prescribe one or more indices in lieu of the average mid-term AFR to be used in determining the permissible range.

The bill provides that certain service may be disregarded at the employer's election in calculating the plan's current liability. In the case of certain participants, the applicable percentage of the years of service before the individual became a participant are taken into account in determining current liability. The applicable percentage is (1) 0, if the individual has 5 or less years of participation, (2) 20, if the individual has 6 years of participation, (3) 40, if the individual has 7 years of participation, (4) 60, if the individual has 8 years of participation, (5) 80, if the individual has 9 years of participation, and (6) 100 if the individual has 10 or more years of participation. Partial years of participation are rounded to the nearest whole year.

The rule disregarding pre-participation service is available with respect to any participant who, at the time of becoming a participant, has not accrued any other benefits under any defined benefit pension plan (whether or not terminated) of the employer or the employer's controlled group, and has years of service before such time in excess of the years of service required for eligibility to participate in the plan. The rule applies only with respect to new participants in years beginning after December 31, 1987.

The bill provides that unfunded current liability means, with respect to any plan year, the excess of (1) the current liability under the plan over (2) the value of the plan's assets reduced by any credit balance in the funding standard account. The funded current liability percentage of a plan for a plan year is the percentage that (1) the value of the plan's assets reduced by any credit balance in the funding standard account is of (2) the current liability under the plan.

Unfunded old liability amount

The unfunded old liability amount is, in general, the amount necessary to amortize the unfunded old liability under the plan in equal annual installments (until fully amortized) over a fixed period of 15 plan years (beginning with the first plan year beginning after December 31, 1987). The "unfunded old liability" with respect to a plan is the unfunded current liability of the plan as of the beginning of the first plan year beginning after December 31, 1987, determined without regard to any plan amendment adopted after October 16, 1987, that increases plan liabilities (other than amendments adopted pursuant to collective bargaining agreements described in the following paragraph).

Under a special rule applicable to collectively bargained plans, increases in liabilities pursuant to a collective bargaining agreement ratified before October 17, 1987, are also amortized over 15 years. Thus, under the bill, the unfunded old liability amount with respect to a collectively bargained plan is increased by the amount necessary to amortize the unfunded existing benefit increase liabilities in equal annual installments over a fixed period of 15 plan years, beginning with the plan year in which the increase in liabilities occurs pursuant to the bargaining agreement. For purposes of this rule, the unfunded existing benefit increase liability means the unfunded current liability determined by taking into account only (1) liabilities attributable to the increase in liabilities pursuant to the agreement, and (2) the value of assets in excess of current liability (determined without regard to the liabilities described in (1)).

The employer may elect to amortize unfunded existing benefit increase liability under an alternative rule instead of the rule described above. Under the alternative rule, the increases in liabilities under the collective bargaining agreement would be calculated as of the beginning of the first plan year beginning after December 31, 1987. This amount would be included in calculating the initial unfunded old liability and, together with any other unfunded old liability, would be amortized over 15 years (beginning with the first plan year beginning after December 31, 1987).

For purposes of determining the unfunded existing benefit increase liability, any extension, amendment, or other modification of a bargaining agreement after October 16, 1987, is not taken into account. In general, the unfunded existing benefit increase liability only includes increases in liability pursuant to the bargaining agreement and therefore does not include liability increases with respect to individuals covered by the plan who are not subject to the collective bargaining agreement. However, if more than 75 percent of the employees covered by the plan on October 16, 1987, are subject to the collective bargaining agreement, then the unfunded existing benefit increase liability includes the liability with respect to all employees in the plan whose benefits are determined directly or indirectly by reference to the terms of the bargaining agreement. Separate plans may not be treated as a single plan for purposes of this rule, even if the benefits under the plans are coordinated.

For example, assume a benefit increase under a collective bargaining agreement ratified before October 17, 1987, takes effect on January 1, 1989, and that the liability due to the benefit increase is \$10*x*. The current liability of the plan determined without regard to the benefit increase is \$100*x*, and the value of plan assets if \$105*x*. The plan year is the calendar year. The unfunded existing benefit increase liability is \$5*x*. This amount will be amortized over 15 years, beginning in 1989.

Alternatively, instead of amortizing the benefit increase as described above, the employer could elect to add the liability due to the increase (calculated as of January 1, 1988) to the unfunded old liability (determined without regard to the benefit increase) and amortize the entire amount over 15 years beginning in 1988.

Unfunded new liability amount

The unfunded new liability amount for a plan year is the applicable percentage of the plan's "unfunded new liability." "Unfunded new liability" means the unfunded current liability of the plan for the plan year, determined without regard to (1) the unamortized portion of the unfunded old liability and (2) the liability with respect to any unpredictable contingent event benefits, without regard to whether or not the event has occurred. Thus, in calculating the unfunded new liability, all unpredictable contingent event benefits are disregarded, even if the event on which that benefit is contingent has occurred.

If the funded current liability percentage is less than 35 percent, then the applicable percentage is 30 percent. The applicable percentage decreases by .25 of one percentage point for each 1 percentage point by which the plan's funded current liability percentage exceeds 35 percent. For example, if the funded current liability percentage is 55 percent, then the applicable percentage is 25 percent, and the unfunded new liability amount for the plan year is 25 percent of the unfunded new liability. Similarly, if the funded current liability percentage is 80, then the applicable percentage is 18.75 and the unfunded new liability amount for the plan year is 18.75 percent of the unfunded new liability.

Unpredictable contingent event benefits

Unpredictable contingent event amount

If the event on which an unpredictable contingent event benefit is contingent occurs during the plan year and the assets of the plan are less than current liability (calculated after the event occurred), then an additional funding contribution (over and above the minimum funding contribution otherwise due) is required. The amount of the required additional contribution is generally equal to the greater of (1) the amount of unpredictable contingent event benefits paid during the plan year (regardless of the form in which paid), including (except as provided by the Secretary of the Treasury) any payment for the purchase of an annuity contract with respect to a participant with respect to such benefits, and (2) the amount that would be determined for the year if the unpredictable contingent event benefit liabilities were amortized in equal annual installments over 5 years, beginning with the plan year in which the event occurs. For the year in which the event occurs, an amount equal to 150 percent of the amount determined under (1) above may, at the employer's election, be treated as the unpredictable contingent benefit amount. In no case, however, with the unpredictable contingent event amount exceed the unfunded current liability (including the liability due to the contingent event benefit) of the plan.

If the event on which an unpredictable contingent event benefit is contingent occurs during the plan year and the assets of the plan equal or exceed current liability (calculated after the event has occurred), then the employer may continue to fund the plan's unpredictable contingent event benefits as under present law (i.e., generally as an experience loss), subject to the application of the special rule if the plan's funding falls below current liability.

PBGC guarantee

The bill provides that the PBGC guarantee with respect to an unpredictable contingent event benefit does not begin to phase in until the event on which the benefit depends occurs. Thus, for purposes of the phasein, any plan or plan amendment providing for an unpredictable contingent event benefit is not treated as in effect with respect to such benefit until the month in which the event on which the benefit depends occurs. In no case is the bill intended to expand the scope of PBGC guaranteed benefits.

Adjustments

The Secretary of the Treasury is to prescribe appropriate adjustments in the unpredictable contingent event amount, the old liability amount, the new liability amount, and the other charges and credits under section 412 as are necessary to avoid inappropriate duplication or omission of any factors in the determination of such amounts, charges and credits (for example, adjustments reflecting assets appreciation or depreciation).

It is also intended that the Secretary will provide special rules for multiple-employer plans where appropriate.

Small plan exception

The new funding rules for plans with assets less than current liability do not apply to a plan with no more than 100 participants on any day in the preceding plan year. In the case of a plan with more than 100 but no more than 150 participants during the preceding year, the amount of the additional contribution is determined by multiplying the otherwise required additional contribution by 2 percent for each participant in excess of 100. For purposes of this rule, all defined benefit plans (including multiemployer plans) of the employer and the employer's controlled group are treated as a single plan. Controlled group is defined as in section 414 (b), (c), (m) and (o). With respect to a multiemployer plan, only employees of the employer (or a controlled group member) are taken into account.

Valuation regulations

The bill provides that, effective with respect to plan years beginning after December 31, 1987, the regulations permitting asset valuations to be based on a range of other than fair market value are to have no force and effect. In addition, the bill provides that the Secretary of the Treasury is to amend the regulations to carry out the intent of this provision.

Effective Dates

In general, the changes in the minimum funding requirements for defined benefit pension plans apply with respect to plan years beginning after December 31, 1987. Contingent even benefits with respect to which the event has occurred before October 17, 1987, are not subject to the new funding rule for such benefits. If the event has not occurred on or before October 16, 1987, such benefits are subject to the new funding rules for such benefits. The new phase-in of the PBGC guarantee with respect to unpredictable contingent event benefits applies to increases in a plan's unpredictable contingent event benefits after October 16, 1987 (other than increases pursuant to a collective-bargaining agreement ratified before October 17, 1987). A plan's unpredictable contingent even benefits on October 16, 1987, are determined by reference to the benefit formula in effect on such date (including any age and/or service eligibility conditions in effect on such date) and by disregarding salary increases and service after such date. Service after such date is taken into account for purposes of determining satisfaction of eligibility conditions.

b. Time for making contributions (sec. 6622 of the bill)

Present Law

Under present law, an employer is treated as making a contribution that satisfies its minimum funding requirement for a plan year if the contribution is made within 8½ months after the close of the plan year. Of that 8½-month grace period for making plan contributions, 6 months were provided under Treasury regulations.

Reasons for Change

In light of the GAO report, the committee does not believe that it is appropriate to permit employers to make no contributions until 8½ months following the end of the plan year. The GAO report found that a significant amount of claims against the PBGC occurred when plan contributions for a year were not made because the payment deadline expired after the date of plan termination.

Further, the committee believes that requiring quarterly plan contributions could provide an early warning to the PBGC, the IRS, and to plan participants of possible employer difficulty in meeting its funds obligations. Such an approach is consistent with other tax laws, such as those requiring withholding taxes and estimated tax payments to be made on a quarterly basis. Because the bill requires that a significant portion of the year's contribution be made in installments during the plan year, the committee does not believe that it is necessary to accelerate the 8½-month period for making the final plan contribution.

In addition, the committee is concerned that under present law, employees do not receive adequate information relating to the funded status of a plan maintained by the employer. As a result, employees may make retirement planning decisions without knowledge of the risk that they will not receive their promised benefits under the employer-maintained plan. Accordingly, the committee believes that employees should be aware of whether or not the employer is making required contributions to the plan so that each employee may assess the risk that the employer's plan will not have sufficient assets to pay benefits when due.

In order to ensure that contributions are actually paid to the plan, the committee also believes it is appropriate to provide for a lien in favor of the plan if contributions are missed.

Explanation of Provisions

Quarterly payments of estimated required contribution

Under the bill, 4 installment payments of minimum funding contributions are required for each plan year. The due dates of these 4 required installments are, in the case of a calendar year plan year, April 15, July 15, October 15, and January 15 of the following year.

The amount of each required installment is 25 percent of the required annual payment.

The bill defines the required annual payment to be the lesser of (1) 90 percent of the amount the employer is required to contribute for the plan year under the minimum funding requirements (other than the unpredictable contingent event amount) or (2) 100 percent of the amount the employer was required to contribute for the preceding plan year (other than the unpredictable contingent event amount) with respect to the plan and any predecessor plans. The second rule does not apply if the preceding plan year was less than 12 months. The unpredictable contingent event amount is required to be contributed in addition to the installment contributions otherwise due. Thus, for example, if the unpredictable contingent event amount for a quarter is equal to the amount of payments of unpredictable contingent event benefits, such amount is required to be contributed at the same time and in addition to the otherwise required next quarterly installment.

In the case of a plan year that is not a calendar year, the due dates of the required installments are (1) the 15th day of the 4th month, (2) the 15th day of the 7th month, and (3) the 15th day of the 10th month following the beginning of the plan year, and (4) the 15th day of the 1st month following the beginning of the following plan year. Under the bill, the due dates of required installments in the case of a short plan year are to be determined under Treasury regulations.

If a required installment is not paid to the plan by the due date for the installment the funding standard account is charged with interest on the amount of the underpayment for the period of the underpayment. The amount of the underpayment is determined by subtracting the installment payments made on or before the due date of the installment from the required installment.

The period of the underpayment is the period from the due date of the installment to the earlier of (1) the contribution due date for the plan year (i.e., 8-½ months following the end of the plan year), or (2) with respect to any portion of an underpayment, the date on which the portion is contributed to the plan. Contributions are credited first to the underpayments arising first.

The rate of interest is the greater of 175 percent of the Federal mid-term rate (AFR) or the rate of interest used under the plan in determining costs.

Notice of failure to meet minimum funding standards

The bill requires that the employer is to notify participants and beneficiaries if the employer fails to make a required installment or fails to make the final contribution (i.e., the contribution required by 8-½ months following the end of the plan year).

Imposition of lien

If the employer fails to make a required contribution (including a required installment payment) when due, a lien arises in favor of the plan in the amount of the missed contribution (including interest). The lien is on all property and rights to property, whether real or personal, belonging to the contributing sponsor and members of the controlled group of the contributing sponsor. The lien generally arises 30 days after the due date of the contribution, and continues until the payment of such contribution (including interest). However, if a timely request for a funding waiver is made with respect to the contribution, then the lien does not arise until the day after the waiver is denied. No lien arises if the waiver is granted. The employer is required to notify the PBGC of any failure to make a required contribution within 10 days after the due date of the contribution.

If the employer fails to make successive contributions, the lien previously in existence under this provision does not terminate. Rather, the provision operates with respect to each successive missed contribution.

The lien may be perfected and enforced only by the PBGC or, at the direction of the PBGC, by the contributing sponsor or any member of the controlled group of the contributing sponsor. Rules similar to the rules in section 4068 (c), (d), and (e) of ERISA apply with respect to the lien and the amount on which the lien is based. A perfected lien is treated as a Federal tax lien, and an unperfected lien is treated as a Federal tax claim.

Effective Dates

The provisions are effective for plan years beginning after December 31, 1987. Under a transition rule, the amount of each required installment payment (other than payments of the unpredictable contingent event amount) is (1) 5 percent for plan years beginning in 1988, (2) 10 percent for plan years beginning in 1989, (3) 15 percent for plan years beginning in 1990, and (4) 20 percent for plan years beginning in 1991.

c. Liability of members of controlled group for taxes on failure to meet minimum funding standards (sec. 6623 of the bill)

Present Law

If, as of the close of any plan year, the minimum required contribution has not been made and charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." Unless a minimum funding waiver is obtained, an employer who is responsible for contributing to a plan with an accumulated funding deficiency is subject to a 5-percent nondeductible excise tax on the amount of the deficiency (Code sec. 4971). If the deficiency is not corrected within the "taxable period," then an employer who is responsible for contributing to the plan is also subject to a nondeductible excise tax equal to 100 percent of the deficiency. The taxable period is the period beginning with the end of the plan year in which there is a deficiency and ending on the earlier of (1) the date of a mailing of a notice of deficiency with respect to the 5-percent tax or (2) the date on which the 5-percent tax is assessed by the Internal Revenue Service (IRS).

The excise taxes imposed for a failure to meet the funding requirements applicable to a plan are imposed only on an employer who is responsible for contributing to the particular plan in which the deficiency arises. Another taxpayer that is a member of the same controlled group of corporations or trades or businesses as the employer is not liable for a funding deficiency unless the other taxpayer is also responsible for contributing to that plan. Under proposed regulations, the entire controlled group would be liable for any excise taxes imposed for a failure by a member of the group to satisfy the minimum funding requirements.

Reasons for Change

The committee believes that the present-law rules relating to the liability to make contributions to a pension plan enable an employer that is a member of a controlled group to avoid its liabilities when it is unable to make a required contribution even though other members of the employer's controlled group have sufficient assets to make the employer's required contribution. The committee finds that the failure to impose liability for the contributions on a controlled group basis increases the potential risk to plan participants and the PBGC.

In addition, in light of the GAO report, the committee believes that increases in the taxes for failure to make contributions are needed to help ensure that contributions are made when due.

Explanation of Provision

Under the bill, as under present law, the employer who maintains a pension plan is liable for any excise taxes imposed for a failure to meet the minimum funding standards (Code sec. 4971). In addition, if the employer is a member of a controlled group, each member of the employer's controlled group is jointly and severally liable for such excise taxes.

Under the bill, a controlled group is any group of employers treated as a single employer under section 414 (b), (c), (m), or (o).

The bill also increases the amount of the first-tier excise tax from 5 percent to 10 percent.

Effective Date

The provision is effective for taxes imposed with respect to plan years beginning after December 31, 1987.

d. Funding waivers (sec. 6624 of the bill)

Present Law

Within limits, the IRS is permitted under present law to waive all or a portion of the contributions required under the minimum funding standard for a plan year. Generally, the IRS has required that a request for a waiver be submitted by the end of the plan year following the plan year for which the waiver is requested. A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without substantial business hardship and failure to grant the waiver would be adverse to the interests of plan participants in the aggregate. The IRS generally takes the position that a waiver will not be granted unless the hardship is temporary and the employer demonstrates that recovery is likely. Under present law, an employer is required to notify each employee organization representing employees covered by the plan of an application for a funding waiver. No more than 5 waivers may be granted within any period of 15 consecutive plan years.

A waived contribution is a waived funding deficiency. Under the funding standard, the amount of a waived funding deficiency is amortized over a period of 15 plan years, beginning with the year following the year for which the waiver is granted. Each year, the funding standard account is charged with the amount amortized for that year unless the plan becomes fully funded. Interest on the waived amount is equal to the rate applicable to late payment of taxes (Code sec. 6621(b)). The IRS generally allows deductions for contributions made to amortize waived deficiencies more quickly than over 15 years. (See, e.g., Rev. Rul. 78-223, 1978-1 C.B. 125.)

Reasons for Change

The committee believes that employers have used funding waivers in the past to minimize plan contributions during the period immediately preceding the termination of a plan. The GAO report found that 30 percent of the claims against the PBGC arising during the period 1983-1985 resulted from the failure of employers to make required plan contributions prior to plan termination. The GAO concluded that significant percentages of the large claims represented required contributions that were overdue or had been waived by the IRS.

Under present law, funding waivers are equivalent to an extension of credit from a plan to the employer that normally would be treated as a prohibited transaction. The committee does not believe that such an extension of credit is appropriate unless adequate safeguards apply to protect participants' benefits. Plan participants should not be required to finance the continuing operations of an employer by placing their retirement benefits at risk.

Further, the committee believes that the integrity of the plan termination insurance program will be jeopardized if employers have the opportunity to avoid liability for their pension promises at the expense of other employers who moderated their promises or are more financially secure and remain in the defined benefit system.

Explanation of Provision

The bill modifies the rules governing the availability of minimum funding waivers in several respects. Under the bill, a waiver application is required to be filed no later than the due date for the contribution (including required installments). Thus, a waiver for a quarterly installment must be made by the due date for the installment.

The standards for obtaining a waiver are clarified by incorporating in the statute the present-law requirement that the employer seeking a waiver is required to establish that the financial hardship is temporary. The committee directs the IRS to apply the temporary hardship standard to prevent the granting of funding waivers to employers that will not recover sufficiently to make their waived contributions. Because all members of the controlled group of the employer maintaining the plan are liable for excise taxes under the minimum funding rules, the hardship determination is based, under the bill, upon the circumstances of the entire controlled group, as well as the circumstances of the particular employer.

In order to make funding waivers more equivalent to commercial loans, the bill provides that the interest rate on waived contributions for purposes of determining the amortization charge for waived amounts is increased from the interest rate applicable to the late payment of taxes to the greater of the plan's interest rate for funding purposes or 150 percent of the Federal mid-term rate (as in effect under sec. 1274 for the first month of the plan year). The interest rate based on the Federal mid-term rate is intended to be an administrable measure of a market interest rate for borrowing by a distressed company.

To protect plans against protracted periods of serious underfunding and serious deterioration of the funded status of the plan, the bill provides that a funding waiver may not be granted with respect to a plan that has assets less than current liability. The determination of whether a plan has assets less than current liability is to be made at the beginning of the plan year or at such other time as determined by the Secretary.

In addition, the bill reduces the number of waivers that may be granted with respect to any plan within a 15-year period from 5 to 3. A single waiver request may be made with respect to all quarterly contributions for a year and the final required contribution.

The committee does not intend that the bill will affect the administrative practice of the IRS under which deductions are allowed for contributions that amortize waived funding deficiencies more rapidly than the required amortization.

Effective Dates

The provision relating to funding waivers is effective with respect to any application for a funding waiver submitted with respect to plan years beginning after December 31, 1987. With respect to the rule restricting the number of waivers in a 15-year period, waivers granted prior to the effective date are taken into account.

e. Amortization periods (sec. 6625(a) of the bill)

Present Law

In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typicially involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. The actuarial assumptions are required to be reasonable in the aggregate. If, on the basis of these assumptions, the contributions made to the plan result in actual unfunded liabilities that are less than anticipated by the actuary, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. For a single-employer plan, experience gains and losses for a year are amortized over a 15-year period.

If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the liability of a plan is less than the liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the liability, the plan has a loss from changes in actuarial assumptions. The gain or loss for a year from changes in actuarial assumptions is amortized over a period of 30 plan years.

Reasons for Change

The committee believes that the present-law amortization period for experience gains and losses delays unnecessarily the reconciliation of actual experience and actuarial assumptions. The present-law amortization period for experience losses contributes to underfunding and thereby undermines benefit security and increases the risk of loss to the PBGC. The present-law amortization period for experience gains similarly contributes to inappropriate overfunding because such gains are taken into account over a long period.

Similarly, the committee believes that the present-law amortization period for gains and losses resulting from changes in actuarial assumptions delays unnecessarily the reconciliation of the old assumptions with the new assumptions. In addition, the lengthy amortization period provided under current law may contribute to undue manipulation of plan assumptions.

Explanation of Provision

Under the bill, the period for amortizing experience gains and losses is reduced to 5 years from 15 years. The period for amortizing gains and losses from changes in assumptions is reduced to 5 years from 30 years.

Effective Date

The provision is effective for gains and losses arising in plan years beginning after December 31, 1987. The bill does not affect the amortization period applicable to gains and losses arising in plan years beginning before January 1, 1988.

f. Actuarial assumptions must be reasonable (sec. 6625(b) of the bill)

Present Law

Under present law, the actuarial assumptions used to determine costs, liabilities, interest rates, and other factors under a plan are required to be reasonable in the aggregate. Present law does not require any individual actuarial assumption to be reasonable.

Reasons for Change

The present-law rule for actuarial assumptions presents significant compliance problems for the IRS. It is substantially more difficult for the IRS to establish that a plan's funding is determined on the basis of actuarial assumptions that are, in the aggregate, unreasonable than to challenge any individual assumption.

The committee believes that these administrative problems reduce the ability of the IRS to require an employer to make plan contributions necessary to meet the plan's benefit obligations.

In addition, the committee is aware that some employers who wish to maximize their tax deferral or obtain a larger tax deduction in a particular year use unrealistic actuarial assumptions (such as an extremely low interest rate assumption) in order to generate larger plan contributions and deductions. The inability of the IRS to challenge individual actuarial assumptions makes it more likely that employers who want to manipulate the present-law rules may do so.

Explanation of Provision

The bill modifies the standard for actuarial assumptions to require that all costs, liabilities, interest rates, and other factors are to be determined on the basis of actuarial assumptions and methods (1) each of which is reasonable (taking into account the experience of the plan and reasonable expectations) or (2) which result, in the aggregate, in a total plan contribution equivalent to the contribution that would be obtained if each assumption were reasonable. Under the bill, as under present law, the costs, etc., are required to represent the plan actuary's best estimate of anticipated experience under the plan. The committee intends that the taxpayer has the burden of demonstrating that each actuarial assumption is reasonable and, if each actuarial assumption is not reasonable, that the assumptions in the aggregate result in a total contribution equivalent to the contribution that would be obtained if each assumption were reasonable.

Effective Date

The provisions are effective for plan years beginning after December 31, 1987.

g. Limitation on deduction for contributions to certain plans not less than unfunded current liability (sec. 6625(c) of the bill)

Present Law

Under present law, an employer may deduct contributions to a pension plan, within limits. In the case of a defined benefit pension plan, an employer's contributions to a plan may not be deductible even though the sum of the contributions plus the plan assets do not exceed the plan's current liability for the plan year.

Reasons for Change

Under the bill, underfunded plans are subject to an exposure-related PBGC premium based on the amount of underfunding as a function of current liability. The committee believes that it would be unfair to impose the exposure-related premium if the employer is willing to fund the plan up to the level of current liability.

Explanation of Provision

The bill provides that the maximum deduction limit for contribution to certain defined benefit pension plans for a plan year is not to be less than the unfunded current liability for the plan. Current liability is determined as under the minimum funding rules. Thus, if the employer elects to take pre-participation service into account in calculating current liability under the minimum funding rules, such service is also taken into account in calculating current liability for purposes of this deduction rule. Except as provided by the Secretary, contributions to a defined benefit pension plan are deductible under this rule if the plan has 100 or more participants during the plan year. For purposes of the 100-participant rule, all defined benefit plans (including multiemployer plans) maintained by the same employer or any member of such employer's controlled group are to be treated as a single plan. With respect to multiemployer plans, only employees of the employer (or controlled group member) are taken into account.

Effective Date

The provision is effective for years beginning after December 31, 1987.

2. Treatment of Plan Terminations (secs. 6626-6628 of the bill)

Present Law

Law before 1986

Prior to 1986, an employer could, subject to contractual obligations, terminate a single-employer defined benefit pension plan at any time without regard to the financial health of the employer and without regard to the level of assets in the plan. If a terminated single-employer plan had assets that were sufficient to pay benefits at the level guaranteed by the PBGC, the plan was required to pay those benefits to participants and beneficiaries, and the employer had no liability to the PBGC. If a single-employer plan was terminated with assets insufficient to pay benefits at the level guaranteed by the PBGC, the PBGC would pay unfunded guaranteed benefits. The employer was then liable to the PBGC for the insufficiency or for an amount equal to 30 percent of the employer's net worth, if less. The employer had no further liability to plan participants and beneficiaries.

SEPPAA

The Single Employer Pension Plan Amendments Act (SEPPAA), enacted in 1986, substantially modified the rules relating to the termination of single-employer defined benefit pension plans. Under SEPPAA, the conditions under which an employer may voluntarily teminate a plan were revised and an employer's liability to plan participants and the PBGC was increased in the case of a termination of an underfunded plan.

Guaranteed benefits

Subject to limits, the PBGC guarantees basic benefits under a plan. Basis benefits consist of nonforfeitable retirement benefits other than those benefits that become nonforfeitable soley on account of the termination of the plan. ERISA set the maximum guaranteeable benefit at $750 per month in 1974, to be adjusted annually based on the Social Security wage and benefit base. The maximum monthly amount for 1987 is $1,857.95.

Guarantees do not apply with respect to benefits in effect for fewer than 60 months at the time of plan termination unless the PBGC finds substantial evidence that the plan was terminated for a reasonable business purpose and not for the purpose of securing increased guaranteed benefits for participants. In cases in which they apply, guarantees are phased in at the rate of $20 per month or 20 percent per year, whichever is greater, for (1) basic benefits that have been in effect for less than 60 months at the time that the plan terminates, or (2) any increase in the amount of basic benefits under a plan resulting from a plan amendment within 60 months before the date of plan termination.

Standard terminations

After SEPPAA, a single-employer defined benefit pension plan may be voluntarily terminated only in a standard termination or in a distress termination. A plan may be terminated in a standard temination only if it has sufficient assets to pay all benefit commitments under the plan. Benefit commitments are greater than guaranteed benefits, and include all benefits guaranteed by the PBGC and all benefits that would be guaranteed but for the dollar limit on the guarantee or the length of time the benefit has been in existence (the phase-in rule). In addition, benefit commitments include early retirement supplements or subsidies and plant closing benefits with respect to participants who have satisfied all conditions for entitlement prior to termination, without regard to whether such benefits are guaranteed.

Benefit commitments are less than plan termination liability. Termination liability represents all benefits that have been promise under the plan up to the date of plan termination, and consists of all fixed and contingent liabilities to plan participants and beneficiaries. Benefit commitments can be signficantly less than termination liability. For example, benefit commitments do not include benefits that vest solely due to plan termination or contingent benefits (such as early retirement benefits) for which the participant has not satisifies all conditions for entitlement prior to termination; these benefits are, however, included in termination liability.

If a plan is terminated in a standard termination so that the plan assets are sufficient to satisfy benefit commitments, then the employer has no further liability to plan participants, even if the plan is not sufficiently funded to meet termination liabilities.

Distress terminations

A plan with assets insufficient to provide benefit commitments may be terminated in a distress termination only if the PBGC determines that each contributing sponsor and each substantial member of the contributing sponsors' controlled group satisfies at least 1 of 4 distress standards established by SEPPAA. An entity is a contributing sponsor if it (1) is responsible for funding the plan or (2) is a member of the controlled group of an entity that is responsible for funding, has been responsible for funding the plan, and has employed a significant number of participants under the plan while it was so responsible. The term "controlled group" means a group of entities under common control. A "substantial member" of a controlled group is generally any entity whose asset comprise at least 5 percent of the assets of the controlled group.

In order to terminate a plan in a distress termination, a plan administrator is required to demonstrate that each contributing sponsor and each substantial member of each contributing sponsor's controlled group meets one of the following criteria: (1) a petition in bankruptcy or a State insolvency proceeding has been filed seeking liquidation of the entity and the petition has not been dismissed; (2) a petition in bankruptcy or a State insolvency proceeding has been filed seeking reorganization of the entity (or a case described in (1) has been converted to a reorganization), the petition has not been dismissed, and the bankruptcy court has approved the plan termination; (3) unless a distress termination occurs, the entity will be unable to pay its debts when due and will be unable to continue in business; or (4) with respect to the entity, the costs of providing pension coverage have become unreasonably burdensome, solely as a result of a decline in the workforce covered as participants under single-employer defined benefit pension plans of which the entity is a contributing sponsor.

In a distress termination, if there are benefit commitments in excess of PBGC-guaranteed benefits that cannot be paid out of current plan assets ("outstanding benefit commitments"), then the PBGC is required to appoint an independent fiduciary with respect to a special termination trust maintained for the benefit of participants. Each contributing sponsor of the plan and each member of the controlled group of a contributing sponsor is jointly and severally liable to the termination trust for the lesser of (1) 75 percent of the outstanding benefit commitments, or (2) 15 percent of the total benefit commitments.

In general, payment of liability by a contributing sponsor to a termination trust is to be made under commercially reasonable terms, with deferrals of certain amounts in years in which no person liable for the payment has pre-tax profits. Such deferred amounts are only payable after similar deferrals with respect to liability to the PBGC have been paid in full. However, there is no assurance that amounts will not be paid to plan participants before the employer's full liability to the PBGC has been discharged.

In a distress termination, if the plan assets are insufficient to fund guaranteed benefits, each contributing sponsor and each member of the controlled group of each contributing sponsor is jointly and severally liable to the PBGC for the sum of (1) the outstanding balance of any accumulated funding deficiency, and (2) the balance of the amount of any waived funding deficiencies. The full amount of a contributing sponsor's liability to the PBGC is due and payable as of the date of plan termination.

In addition, upon the termination of a plan pursuant to a distress termination, each contributing sponsor of the plan and each member of the controlled group of each contributing sponsor is jointly and severally liable to the PBGC for the sum of (1) the total amount of all unfunded guaranteed benefits, up to 30 percent of the collective net worth of the entities that are liable, (2) the excess of 75 percent of the unfunded guaranteed benefits over 30 percent of the collective net worth of the entities that are liable, and (3) interest on such amounts from the date of termination. Payment of this liability is generally to be made based on commercially reasonable terms, with deferrals of certain amounts in years in which the liable entities have no pre-tax profits.

The rules described above apply without regard to whether the employer or any member of the controlled group also maintains one or more plans that have assets in excess of termination liabilities.

PBGC claims in bankruptcy

Under present law, up the 30-percent of net worth limit, the PBGC's claim has the priority status of a Federal tax for bankruptcy purposes. The remainder of the PBGC's claim generally has a lower priority status, that of an unsecured claim.

Termination by PBGC

The PBGC is authorized to commence proceedings to terminate a plan under certain circumstances and is required to do so if the plan does not have assets available to pay benefits that are currently due under the terms of the plan.

Reasons for Change

Standards for termination

The SEPPAA distress termination standards still permit ongoing, healthy companies to shift liabilities to the PBGC. Under SEPPAA, an employer in financial distress may terminate an underfunded plan pursuant to a reorganization while operating at a profit following the reorganization. This ability may also create a competitive disadvantage for other companies in the same industry that have not reorganized and have not reduced their liabilities. The committee believes that a distress termination should not be available in these circumstances.

Lien rules

While eliminating a reorganization as a condition permitting a distress termination, the committee believes it is appropriate to add safeguards to protect the PBGC's and participants' interest in a reorganization or other bankruptcy proceeding.

The GAO Report stated that, as of January 1986, the PBGC had recovered or expected to recover only 14 percent of its total claims in 1983–1985. The report concluded that this low recovery was due to 2 factors. First, recovery was low because the 30 percent of net worth limit on employer liability prevented the PBGC from recovering the full amount of guaranteed benefits. Second, the PBGC claim has priority status in bankruptcy only up to the 30 percent of net worth limit. Because most claims for due but unpaid contributions exceed this limit, they (with limited exceptions) have a low priority in bankruptcy, that of an unsecured claim. Contributions that were due but unpaid as of the termination were the cause of 30 percent of the PBGC's claims in 1983-1985.

The GAO report concluded that increasing liability to the PBGC would improve the recovery rate, but would not be sufficient to reduce the potential liability of the PBGC. According to the report, a major problem continues to be the low priority of PBGC claims in bankruptcy. SEPPAA increased the ability of the PBGC to secure its claim by requiring security in the case of certain funding waivers. Even if SEPPAA had been in effect with respect to the claims on the PBGC during 1983-1985, however, the GAO found that only 4 percent of the total claims for the period could have been secured by the PBGC. The report recommended that the priority of PBGC claims in bankruptcy be increased.

The committee believes that appropriate measures are necessary in order to better protect the PBGC and plan participants in the case of bankruptcy. Accordingly, the bill provides that the plan is entitled to security in certain cases in which there is risk of loss to the PBGC or plan participants.

Employer liability

Present law places limits on the liability of the employer to plan participants and the PBGC. Under present law, plan participants may lose their right to pension benefits if a plan is terminated with assets less than termination liability because the employer is not fully liable for unfunded benefits and because the PBGC has no liability for benefits in excess of guaranteed benefits. Similarly, if a plan terminates with assets less than guaranteed benefits, the PBGC may not be made whole with respect to the benefits it pays participants because the employer is not fully liable to the PBGC for unfunded guaranteed benefits.

The limits on employer liability under present law may also adversely affect the funding of plans because certain employers have insufficient incentive to fund a plan in excess of the level of benefit commitments. This disincentive may increase the likelihood that participants will not receive their full pension benefits and that the PBGC will have to provide unfunded guaranteed benefits.

In order to encourage employers to fund promised benefits, ensure that plan participants receive promised benefits, and ensure that the PBGC is made whole with respect to guaranteed benefits it pays, the committee believes that employers should be fully liable for their pension promises.

Explanation of Provisions

Employer liability

Under a bill, the required plan asset level for a standard termination is increased from the present-law requirement of benefit commitments to the full level of the plan's termination liability to participants. As under present law, the plan's termination liability is all liabilities to employees and their beneficiaries under the plan, and includes all fixed and contingent benefits that would be provided if the plan had sufficient assets (Code sec. 401(a)(2)) of course, such liability is to be determined without regard to the level of plan assets.

Under the bill, a defined benefit pension plan with assets insufficient to provide its termination liability to participants is unable to terminate unless the employer (and controlled group) can satisfy the criteria for a distress termination. Following a distress termination, the employer's (and controlled group's) liability to participants is increased from the present-law percentage of benefit commitments to the full amount of the plan's unfunded termination liability to the extent not guaranteed by the PBGC, and the employer's (and controlled group's) liability to the PBGC is increased to termination liability.

Standards for termination

The bill provides that a reorganization does not qualify as a condition under which a distress termination is permitted. Thus, under the bill, in order to terminate a plan in a distress termination, a plan administrator is required to demonstrate that each entity that is a contributing sponsor or a member of a contributing sponsor's controlled group meets one of the following criteria: (1) a petition in bankruptcy or a State insolvency proceeding has been filed seeking liquidation of the entity and the petition has not been dismissed or converted to a petition seeking reorganization, (2) unless a distress termination occurs, the entity will be unable to pay its debts when due and will be unable to continue in business, or (3) with respect to the entity, the costs of providing pension coverage have become unreasonably burdensome, solely as a result of a decline in the workforce covered as participants under single-employer pension plans of which the entity is a contributing sponsor.

Lien rules

Consistent with the increase in the liability of the employer to the PBGC, the bill removes the 30-percent of net worth limitation on the amount of the PBGC lien that arises upon plan termination.

In addition, under the bill, a statutory lien arises in favor of the plan to the extent that as of the close of a plan year (1) the plan's assets are less than 70 percent of current liability and (2) the unfunded current liability exceeds $25 million. The unamortized portion of the plan's unfunded old liability amount is disregarded in making these determinations. The lien is on all property and rights to property, whether real or personal, belonging to the contributing sponsor and the members of the contributing sponsor's controlled group.

The lien arises on the and continues until the close of the plan year in which the plan is not described in (1) or (2) above. If, from one plan year to the next, the level of unfunded current liability increases, the amount of the lien is increased by the amount of the increase in plan underfunding. The employer is required to notify the PBGC when the plan is described in (1) and (2) above.

Rules similar to the rules in section 4068(c), (d), and (e) of ERISA apply with respect to the lien and the amount on which it is based. As under section 4068(c), a perfected lien is treated as a Federal tax lien, and an unperfected lien is treated as a Federal tax claim.

In addition, any lien created by this provision may be perfected and enforced by the PBGC or, at its direction, by the contributing sponsor or any member of the controlled group of the contributing sponsor.

Effective Dates

With the exception of the provision creating a lien where unfunded current liability exceeds certain levels, the provisions are effective in the case of terminations where notice to the PBGC is provided after October 16, 1987, and terminations instituted by the PBGC after October 16, 1987. The provision creating a lien where unfunded current liability exceeds certain levels is effective with respect to plan years beginning after the date of enactment.

3. Employer Access to Assets of Overfunded Plans

Present Law

Access to plan assets

Under present law, a trust forming part of a pension plan is not qualified under the Code unless it is impossible under the trust instrument, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the trust assets to be used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries. However, upon termination of the plan and after satisfaction of all fixed and contingent liabilities of the participants and beneficiaries (termination liability), the employer may recover any excess assets remaining in the trust that are due to erroneous actuarial computations.

Similarly, under ERISA, the assets of an employee benefit plan may not inure to the benefit of any employer and are to be held for the exclusive purpose of providing benefits to participants in the plan and their beneficiaries and of defraying reasonable expenses of administering the plan. However, any excess assets of a plan may be distributed to the employer upon termination of the plan if (1) all liabilities of the plan to participants and their beneficiaries have been satisfied, (2) the distribution does not contravene any provision of law, and (3) the plan provides for such a distribution.

Under present law, whether the employer has the right to the excess assets of a pension plan or is required to share the excess assets with plan participants is generally determined under the plan document. Thus, if the plan document provides that the employer is entitled to the reversion of excess assets, the employer is not required to share the reversion with participants. A majority of the cases provide that, subject to any applicable collective bargaining agreements, a plan may be amended at any time prior to termination of the plan to provide that the excess assets may revert to the employer.

Upon termination of a plan, all benefits as of the date of termination are required to become 100 percent vested and nonforfeitable. In addition, benefits generally are to be distributed or annuitized.

Implementation guidelines

Although an emplyer is not permitted to recover excess assets except upon termination of a plan, certain procedural guidelines permit transactions that, in effect, permit the withdrawal of assets from an ongoing plan. Typical examples of such transactions are termination-reestablishment and spinoff-termination transactions.

In a termination-reestablishment transaction, the employer terminates a defined benefit plan, recovers the excess assets, and then establishes a "new" plan that generally covers and same employees and provides the same or subtantially similar benefits as the old plan. In a spinoff-termination transaction, a single plan is split into 2 plans, 1 plan covering retirees and 1 covering active employees. The excess assets are allocated to the plan covering retirees. That plan is then terminated, allowing the employer to recover the excess assets.

In response to concern that reversions can reduce the security of participants' benefits, procedural guidelines were developed jointly by the Department of the Treasury, the Department of Labor, and the PBGC. The procedures, referred to as the "Implementation Guidelines for Terminations of Defined Benefit Pension Plans" or the "Implementation Guidelines," were issued by the Administration as a news release on May 24, 1984.

The Implementation Guidelines set forth administrative procedures for processing certain terminations of qualified defined benefit pension plans involving reversions of excess assets to plan sponsor. The guidelines generally provide that a bona fide termination of a defined benefit pension plan will be recognized as having occurred under either a spinoff-termination or a termination-reestablishment transaction only if certain conditions are met.

A spinoff-termination is considered bona fide under the guidelines only if (1) the benefits of all employees are vested as of the date of the termination; (2) all benefits accrued by all employees as of the date of the termination are provided for by the purchase of annuity contracts; (3) the continuing plan adopts a special amortization period (with the approval of the IRS); and (4) appropriate notices is provided to employees.

Under the Implementation Guidelines, termination-reestablishment transactions are generally recognized as bona fide. If the new plan provides credit for service before that plan was adopted, however, the guidelines do not treat the transaction as bona fide unless a special amortization period is adopted (with the approval of the IRS).

The guidelines note that spinoff-terminations or termination-reestablishments may affect the qualified status of plans because the Code requires that qualified plans be permanent. The guidelines generally provide that the permanency requirement prohibits an employer that has engaged in a spinoff-termination or termination-reestablishment transaction from engaging in another such transaction for at least 15 years.

Reasons for Change

The committee believes that the present law standards, as reflected in the Implementation Guildelines, and the present-law excise tax on reversions are appropriate rules for addressing the issue of employer access to excess plan assets.

Explanation of Provision

The bill confirms present law as contained in the Implementation Guidelines.

Effective Date

The provision is a clarification of present law.

4. Increase in PBGC Premium Rates (sec. 6629 of the bill)

Present Law

In general

The PBGC was created in 1974 by ERISA to provide an insurance program for benefits under defined benefit pension plans maintained by private employers. According to the PBGC's latest annual report, the single-employer insurance program currently covers more than 30 million participants in more than 110,000 defined benefit pension plans. PBGC revenues include premiums charged to defined benefit pension plans, earnings on investments, and collections from sponsors of terminated plans.

Premiums

Since its inception, the pension insurance program has charged a flat-rate premium based on the number of plan participants. ERISA initially authorized an annual per-participant premium of $1.00. The premium rate was raised to $2.60 for plan years beginning after December 31, 1977. SEPPAA increased the rate to $8.50, effective for plan years beginning after December 31, 1985.

Liability for premiums

Under present law, the plan administrator is liable for the payment of premiums.

Reasons for Change

The committee recognizes the need to raise the PBGC premium in light of the PBGC deficit. In its report, the GAO estimated that annual premium revenues of $446 million would be needed to retire at $4 billion deficit over 15 years at the PBGC's current interest rates. Projected annual revenue, however, is only $298 million, or 33 percent less than $446 million. Further, the GAO concluded that additional revenues would be needed to pay future expected claims and the program's administrative expenses.

The committee believes it is equitable to base the increased PBGC premium in part on the extent of a plan's underfunded status so that the premium reflects in part the potential PBGC liability created by the plan. However, basing the entire increase on a plan's underfunded status would unduly burden financially distressed plans and employers and could lead to a greater crisis for the PBGC if a significant percentage of these plans were terminated. Thus, the committee believes that some of the necessary revenues should be derived from an increase in the flat premium.

As under the minimum funding rules, the committee believes that the employer sponsoring a plan and related employers should be responsible for liabilities associated with the benefits promised under the plan. Thus, the committee believes that the employer sponsoring the plan and all related employers should be liable for payment of the premium.

Explanation of Provision

Under the bill, the flat-rate per-participant PBGC premium is increased to $14. In addition, the bill applies an exposure-related per-participant premium based on the amount of potential liability the plan creates for the PBGC.

The exposure-related per-participant premium is determined by dividing an amount based on the plan's unfunded current liability by the number of plan participants in the plan at the end of the preceding plan year. The amount based on unfunded current liability is $6.00 for each $1,000 of unfunded current liability as of the end of the preceding plan year. The additional per-participant premium is not to exceed $70 (indexed beginning in 1989 in accordance with the social security benefit and contribution base).

The $70 cap (indexed) is reduced in the case of certain plans. If an employer made the maximum deductible contributions to the plan for 1 or more of the 5 plan years preceding the first plan year beginning after December 31, 1987 (i.e., for a calendar year plan year, 1983–1987), then the cap on the exposure-related premium is reduced by $10 for each plan year for which such contributions were made. The $10 amount is indexed at the same time and same manner as the $70 cap. This special rule operates to reduce the exposure-related premium only for the first 5 plan years the premium is in effect.

As under the new funding rules, the exposure-related premium does not apply to any plan that has no more than 100 participants on each day of the preceding plan year. For purposes of this 100-participant rule, all defined benefit plans (including multiemployer plans) maintained by the same employer (or any member of such employer's controlled group) are treated as one plan. With respect to multiemployer plans, only employees of the employer (or controlled group) are taken into account. In the case of a plan with more than 100 but less than 150 participants on each day during the preceding plan year, the amount of the exposure-related premium is determined by multiplying the otherwise required additional premium by 2 percent for each participant in excess of 100.

In addition, the special rule disregarding certain pre-participation service in calculating current liability under the funding rules applies in calculating current liability for purposes of the exposure-related premium. However, for premium purposes pre-participation years of service are taken into account if the participant has 5 or more years of service.

The bill also provides that, with respect to a single-employer plan, the contributing sponsor, as well as the plan administrator, is liable for payment of the premium and that each member of the contributing sponsor's controlled group is jointly and severally liable for such payment.

Under the bill, all amounts related to the exposure-related premium and the increase in the flat-rate premium are to be deposited in a separate revolving fund. Amounts in this fund may not be used to pay administrative costs of the PBGC or benefits under any plan terminated before January 1, 1988, unless no other amounts are available.

Effective Date

These provisions apply to plan years beginning after December 31, 1987.

Part 2. Technical Corrections Provisions

The technical corrections (Part 2) contains clerical, conforming and clarifying amendments to provisions enacted by the Tax Reform Act of 1986 and other recently enacted legislation. All amendments made by this Part are meant to carry out the intent of Congress in enacting the original legilsation. Therefore, no separate "Reasons for Change" is set forth for each individual amendment.

These provisions are treated as enacted immediately before other provisions of this bill.

TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1986

I. Individual Income Tax Provisions (Sec. 6661 of the Bill)

1. Rate of tax with respect to certain unclaimed cash (sec. 6661(a)(1) of the bill, sec. 101 of the Reform Act, and sec. 6867 of the Code)

Present Law

If the IRS determines that the assessment or collection of tax would be jeopardized by delay, the IRS may use expedited procedures as specified in the Internal Revenue Code (secs. 6851 and 6861). For purposes of these expedited assessment and collection procedures, special rules apply if an individual who is in possession of cash (or cash equivalents) in excess of $10,000 does not claim the cash either as his or as belonging to another identifiable person who acknowledges ownership (sec. 6867).

These rules provide that the cash is presumed to represent gross income of a single individual and that the collection of tax will be jeopardized by delay. Under present law, such income is taxable to the possessor of the unclaimed cash at a 50-percent rate (sec. 6867(b)), i.e., the highest income tax rate imposed by Code section 1 as in effect immediately prior to the rate reductions made by the Act.

Explanation of Provision

The bill provides that the rate of tax applicable with respect to unclaimed amounts of cash described in section 6867 is the highest income tax rate specified in Code section 1. This rate of 38.5 percent for taxable years beginning in 1987 and 28 percent for subsequent years.

2. Rate of accumulated earnings tax (sec. 6661(a)(2) of the bill, sec. 101 of the Reform Act, and sec. 531 of the Code)

Present Law

The Act generally reduces the maximum rate of Federal income tax on individuals to 28 percent, effective for taxable years beginning after 1987. As a conforming amendment, the personal holding company tax rate (sec. 541) also is reduced to 28 percent for taxable years beginning after 1987. However, the Act did not reduce the accumulated earnings tax rate (sec. 531), notwithstanding that each of these additional corporate taxes is imposed to prevent taxpayers from using a corporation to avoid income tax on the corporation's shareholders.

Explanation of Provision

The bill provides that the rate of the accumulated earnings tax will be 28 percent, effective for taxable years of the corporation beginning after December 31, 1987. This amendment shall not be treated as a change in tax rates for purposes of Code section 15.

3. Standard deduction and filing requirement for elderly or blind dependents (sec. 6661(b) of the bill, sec. 102 of the Reform Act, and secs. 63(c)(5) and 6012(a) of the Code)

Present Law

The Act provides a standard deduction for individuals who do not itemize. Elderly or blind taxpayers who do not itemize are allowed an additional standard deduction amount above the basic standard deduction allowed to all nonitemizers.

The additional standard deduction amount is $600 for an elderly or blind individual who is married (whether filing jointly or separately) or is a surviving spouse; the additional amount is $1,200 for such an individual who is both elderly and blind. An additional standard deduction amount of $750 is allowed for a head of household who is elderly or blind ($1,500, if both), or for a single individual (i.e., an unmarried individual other than a surviving spouse or head of household) who is elderly or blind ($1,500, if both). Thus, for example, in 1987 a single elderly individual may claim a basic standard deduction of $3,000 plus an additional standard deduction of $750, for a total of $3,750.

Under the Act, the standard deduction for an individual who may be claimed as a dependent on another taxpayer's return is limited to the greater of $500 or the amount of the individual's earned income (Code sec. 63(c)(5)). The filing threshold for such an individual is the amount of standard deduction that is allowable (sec. 6012(a)(1)(C)).

Explanation of Provision

The bill modifies the standard deduction limitation imposed under section 63(c)(5) on a taxpayer who may be claimed as a dependent on the return of another taxpayer to apply only with respect to the basic standard deduction; thus, the limitation does not also apply with respect to the additional standard deduction amount allowed to elderly or blind individuals.

Accordingly, an elderly or blind individual who may be claimed as a dependent on another taxpayer's return may claim a basic standard deduction up to the greater of $500 or the amount of earned income, plus the additional standard deduction amount (e.g., $600 for a married taxpayer). Since this additional standard deduction amount is not limited by the amount of the dependent's earned income, it may be applied against any remaining income (earned or unearned) that has not been offset by the allowance of the basic standard deduction as described above.

Section 6012(a)(1)(C)(i), which relates to the filing threshold for certain individual taxpayers, is amended to conform to the modification to section 63(c)(5). Thus, for example, an unmarried elderly individual who may be claimed as a dependent on her daughter's tax return must file a return for 1987 only if the elderly individual either (1) has total gross income exceeding $3,750 or (2) has nonearned income exceeding $1,250.

4. Rule for inflation adjustments to earned income credit (sec. 6661(c) of the bill, sec. 111 of the Reform Act, and sec. 32(i) of the Code)

Present Law

The Act modifies the earned income credit to provide for inflation adjustments. An inflation adjustment to the earned income credit is rounded to the nearest multiple of $10 (sec. 32(i)(3)).

Explanation of Provision

Under the bill, the provision relating to rounding of inflation adjustments to the earned income credit applies to the sum of the earned income credit amount (prior to adjustment) plus the inflation adjustment, rather than to the inflation adjustment amount itself. Thus, the statute provides that the dollar amount of the earned income credit after being increased by the inflation adjustment is rounded to the nearest multiple of $10.

5. Cross-references to scholarship exclusion provisions in private foundation rules (sec. 6661(d)(1) of the bill, sec. 123 of the Reform Act, and secs. 4945(g)(1) and 4941(d)(2)(G) of the Code)

Present Law

Code section 4945(g)(1) provides that certain scholarship or fellowship grants that are made by private foundations do not constitute taxable expenditures if the grant "is subject to the provisions of section 117(a)." Section 4941(d)(2)(G) provides that certain scholarship or fellowship grants that are made by private foundations to government officials do not constitute acts of self-dealing if the grants "are subject to the provisions of section 117(a)." The Act limits the section 117(a) exclusion for certain scholarship and fellowship grants made to degree candidates to amounts not exceeding the recipient's tuition and course-related expenses, and repeals the prior-law limited exclusion for nondegree candidates.

Explanation of Provision

The bill amends the cross-references in the private foundation provisions cited above to refer to certain scholarship or fellowship grants that would be the subject to the provisions of Code section 117(a) as in effect prior to its amendment by the Act. Accordingly, the amendments made by the Act to the section 117(a) exclusion do not treat scholarship or fellowship grants made by a private foundation that would not have triggered section 4945 or 4941 excise taxes under prior law as taxable expenditures or self-dealing acts merely because such grants exceed the amount excludable by degree candidates under section 117 as amended by the Act or merely because such grants (up to the amount excludable under prior law) are made to nondegree candidates.

6. Treatment of certain scholarship or fellowship grants to nonresident aliens (sec. 6661(d)(2) of the bill, sec. 123 of the Reform Act, and secs. 1441(b) and 871(c) of the Code)

Present Law

Under present and prior law, Code section 1441(b) provides for a 14-percent withholding rate on amounts received by a nonresident alien who is temporarily present in the United States under an "F" or "J" visa that are "incident to a qualified scholarship to which section 117(a) applies, but only to the extent such amounts are includible in gross income." Under section 871(c), such amounts are subject to U.S. tax on a net income basis.

Under prior law, a nondegree candidate could exclude from gross income under section 117 a limited amount of a scholarship or fellowship granted by an educational institution or other tax-exempt organization described in section 501(c)(3), a foreign government, certain international organizations, or a Federal, State, or local government agency. The prior-law exclusion for a nondegree candidate in any one year could not exceed $300 times the number of months in the year for which the recipient received scholarship or fellowship grant amounts, and no further exclusion was allowed after the nondegree candidate had claimed exclusions for a total of 36 months (i.e., a maximum lifetime exclusion of $10,800). However, this dollar limitation did not apply to that portion of the scholarship or fellowship received by the nondegree candidate for travel, research, clerical help, or equipment.

The Act repeals the limited prior-law exclusion under section 117 for grants received by nondegree candidates. As a result, scholarship or fellowship grants received by nonresident aliens who are nondegree candidates are subject to withholding at a 30-percent rate, and to U.S. tax on a gross income basis, since no amount of such grants is "incident to a qualified scholarship to which section 117(a) applies."

The Act also provides that in the case of a scholarship or fellowship grant received by a degree candidate, an exclusion under section 117 is available only to the extent the individual establishes, in accordance with the conditions of the grant, that the grant was used for (1) tuition and fees required for enrollment or attendance of the student at an educational institution (within the meaning of sec. 170(b)(1)(A)(ii)), and (2) fees, books, supplies, and equipment required for courses of instruction at the educational institution.

Explanation of Provision

The bill provides that withholding at a 14-percent rate applies to amounts received as a scholarship or fellowship for study, training, or research at an educational institution (described in sec. 170(b)(1)(A)(ii)) in the United States by a nonresident alien who is not a degree candidate, if the grant is made by the educational institution or any other tax-exempt organization described in section 501(c)(3), a foreign government, certain international organizations, or a Federal, State, or local government agency. Also, such amounts eligible for the 14-percent withholding rate are subject to U.S. tax on a net income basis under section 871(c).

As under present law, withholding at 14 percent and taxation on a net income basis apply to amounts received by a nonresident alien who is a degree candidate that are incident to a qualified scholarship or fellowship to which section 117(a) applies, but only to the extent includible in gross income (e.g., amounts received for room, board, or travel).

The bill applies the above rules to "M" visa holders as well as "F" and "J" visa holders.[1]

7. Coordination of two-percent floor and certain other deduction limitation provisions (sec. 6661(f)(1) of the bill, sec. 132 of the Reform Act, and sec. 67 of the Code)

Present Law

Code section 67 provides that miscellaneous itemized deductions (generally, certain unreimbursed employee business expenses and certain items allowable under sec. 212) are deductible by itemizers only to the extent that, in the aggregate, they exceed two percent of the taxpayer's adjusted gross income (AGI). Other limitations also apply to particular items that constitute miscellaneous itemized deductions. For example, the last sentence of section 162(a) limits certain deductions for away-from-home living expenses incurred by Members of Congress to $3,000 per year.

Explanation of Provision

The bill clarifies that the two-percent floor on miscellaneous itemized deductions applies prior to application of the $3,000 limitation on certain deductions for Members' away-from-home living expenses. Thus, for example, a Member with AGI of $100,000 who has $5,000 of away-from-home living expense deductions described in section 162(a) (disregarding the dollar limitation contained therein) would be allowed such deductions in the amount of $3,000.[2]

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[1] Similar amendments relating to "M" visa holders are made to Code secs. 3306(c)(19) and 7701(b)(5)(D).

This clarification is consistent with the general rule under the Act to apply certain deduction limitation provisions in the following order: first, provisions disallowing a percentage of a deduction (e.g., sec. 274(n), generally limiting meal and entertainment deductions to 80 percent of the amount otherwise allowable); second, provisions disallowing a fixed dollar amount of certain deductions (e.g., the two-percent floor on miscellaneous itemized deductions); and third, provisions establishing a deduction ceiling (e.g., the $3,000 limit in the last sentence of sec. 162(a), and certain dollar limitations in sec. 217 on deductions for moving expenses).

8. Application of two-percent floor to trusts and estates (secs. 6661(f) (2) and (3) of the bill, sec. 132 of the Reform Act, and sec. 67 of the Code)

Present Law

Under the Act, miscellaneous itemized deductions (generally, certain unreimbursed employee business expenses and items deductible under sec. 212) are deductible only to the extent that, in the aggregate, they exceed two percent of the taxpayer's adjusted gross income (Code sec. 67). In listing the itemized deductions that are not subject to the new two-percent floor, the Act specifically includes the deduction under section 170 (for charitable contributions by individuals or corporations), but does not include the deduction for estates and trusts under section 642(c) (relating to items paid or permanently set aside for a charitable purpose).

Section 67(e) provides that, for purposes of section 67, the adjusted gross income of an estate or trust is computed in the same manner as for an individual, except that certain costs paid in connection with the administration of the estate or trust are treated as allowable in arriving at adjusted gross income. The provision does not state the treatment, for purposes of section 67, of deductions under sections 651 and 661 (relating to certain amounts distributed by a trust or estate).

Section 67(c) provides that Treasury regulations are to (1) prohibit the indirect deduction through pass-through entities of amounts that are not allowable as a deduction if paid or incurred directly by an individual, and (2) contain such reporting requirements as are necessary to accomplish this object. Such regulatory authority does not, however, apply with respect to estates, trusts, cooperatives, and REITs (real estate investment trusts).

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[2] In addition, if a Member has expenses subject to the $3,000 limitation and other miscellaneous itemized deductions, the amounts disallowed by the two-percent floor are disallowed proportionately. For example, assume that a Member with AGI of $100,000 has $5,000 of away-from-home expenses (qualifying for the deduction, disregarding application of the $3,000 limit and the two-percent floor, but after application of the 80-percent rule for meal and entertainment expenses) and $5,000 of other miscellaneous itemized deductions, for a total of $10,000 of potential deductions subject to the two-percent floor. Application of the two-percent floor would limit these deductions to $8,000, and the amount disallowed because of the two-percent floor would be disallowed proportionately. Thus, after application of the two-percent floor, the Member could deduct $4,000 of the away-from-home expenses and $4,000 of the miscellaneous itemized deductions. The former amount (i.e., the away-from-home expenses) is further limited to $3,000 because of the special limitation on deducting Members' expenses in sec. 162(a). Thus, the Member could deduct a total of $7,000 of miscellaneous itemized deductions.

Explanation of Provision

The bill provides that deductions under jurisdiction 642(c) are not miscellaneous itemized deductions subject to the new two-percent floor.

In addition, the bill provides that the distribution deductions allowable to an estate or trusts under sections 651 and 661 are treated as allowable in computing the adjusted gross income of the estate or trust. Similarly, deductions for costs paid or incurred in connection with the administration of an estate or trust, and which would not have been incurred if the property were not held in such trust or estate, are treated as allowable in computing the adjusted gross income of the estate or trust. Thus, deductions under sections 651 and 661, and such administrative costs of an estate or trust, are not limited under the new two-percent floor, and are treated as allowable in arriving at the adjusted gross income of the trust or estate for purposes of section 67.

9. Clarification of exceptions to certain rules limiting meal and entertainment deductions (sec. 6661(g) of the bill, sec. 142 of the Reform Act, and secs. 274(k)(2), 274(m)(1), and 274(n) of the Code)

Present Law

Code section 274(k) denies deductions for the expense of any food or beverages unless such expense is not lavish or extravagant under the circumstances, and unless the taxpayer or an employee of the taxpayer (including, for this purpose, certain independent contractors) is present at the furnishing of such food and beverages. Code section 274(n) generally limits the amount otherwise allowable as a deduction for the expense of any food or beverages, or any entertainment expense, to 80 percent of the amount otherwise allowable. Special limitations apply under section 274(m)(1) to deductions for luxury water transportation. However, the above limitations under the Act do not apply to items that are not treated as entertainment expenses for purposes of section 274(a) by reason of certain of the exceptions listed in section 274(e).

Explanation of Provision

The bill clarifies that the exceptions to sections 274(k)(2), 274(m)(1), and 274(n)(2) described by cross-references to certain paragraphs of section 274(e) are not subject to the limitations of sections 274(k)(2), 274(m)(1), or section 274(n)(2), whether or not such items (disregarding sec. 274(e)) would be treated as entertainment expenses for purposes of section 274(a).

The bill also provides that the Treasury has regulatory authority to provide additional exceptions to the taxpayer-presence requirement in section 274(k)(2). For example, an exception could be provided for meal expenses of the taxpayer's spouse and children incurred by them as moving expenses deductible pursuant to section 217, even though the taxpayer travelled separately to the new job location. As a further example, the taxpayer-presence requirement could be waived by Treasury regulations in the situation where a business reimburses away-from-home meal expenses of a job applicant who travels to the business location the night before his or her job interview and has a meal alone in the hotel where he or she is staying.

Also, the bill resolves a problem under present law involving circular provisions concerning application of the percentage reduction rule with respect to certain reimbursed meal costs deductible as moving expenses, under which the meal reimbursement is excluded from wages for withholding purposes to the extent it is deductible, but the extent of deductibility depends on whether or not the reimbursement is treated as wages.

10. Carryover of excess home office deductions (sec. 6661(h) of the bill, sec. 143 of the Reform Act, and sec. 280A(c)(5) of the Code)

Present Law

Section 280A limits certain deductions with respect to business use of a dwelling unit that is used by the taxpayer during the taxable year as a residence. In general, such deductions, if not wholly disallowed, are limited to the amount of certain income from the business in which they arose. Under the Act, deductions that are disallowed by reason of exceeding the amount of such business income may be taken into account as a deduction (allocable to such business use of the dwelling unit) for the succeeding taxable year (sec. 280A(c)(5)).

Explanation of Provision

The bill clarifies that, when a deduction for business use of a dwelling unit is carried forward to a succeeding taxable year by reason of the business income limitation in section 280A(5), such deduction shall continue to be allowable only up to the amount of income from the business in which it arose, whether or not the dwelling unit is used as a residence during such taxable year.

11. Third-party reimbursements (sec. 6661(b)(3) of the bill and secs. 62 and 527 of the Code)

Present Law

An employee is permitted an above-the-line deduction for employee business expenses incurred "in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer" (Code sec. 62(a)(2)(A)). The conference report on the 1986 Act states that Treasury may prescribe regulations treating reimbursements of employees by third parties in the same manner as reimbursements by employers.[3]

Explanation of Provision

The bill amends the Code to clarify the statutory support for the Treasury regulations called for by the 1986 Act. Thus, an employee who incurs business expenses on behalf of the employer and is reimbursed for those expenses is permitted an above-the-line deduction for those expenses, regardless of whether the reimbursement is provided by the employer or by a third party. To the extent these reimbursements do not exceed the expenses incurred, existing Treasury regulations provide that the employee need not report on the employee's tax return either the expenses or the reimbursements. This rule will also apply regardless of whether the reimbursement is provided by the employer or by a third party.

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[3] See the second sentence of footnote 4, page II-33.

The bill also includes a conforming change to the provision relating to the taxation of political organizations. Thus, for example, a State elected official could be reimbursed by an account authorized under State law (and properly qualified under the Code) to pay the official's office expenses. To the extent those expenses are otherwise deductible business expenses and the reimbursement does not exceed those expenses, the State official would be permitted an above-the-line deduction for those expenses.

12. Treatment of certain mining reclamation payments (sec. 6661 of the bill and sec. 126 of the Code)

Present Law

Present law provides that gross income does not include payments received under specified federal environmental programs, or any state program under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife. A payment qualifies under this provision only if the Secretary of Agriculture determines that it was made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

Reasons for Change

The committee understands that the eligibility of certain payments under this provision has been questioned, on the ground that the program pursuant to which they are made is administered by the Interior Department rather than the Agriculture Department. Moreover, the eligibility of payments made under some state programs has been questioned on the ground that the principal stated purposes of the program is public health and safety. The committee believes that payments should qualify for exclusion under this provision whether the program is administered by the Agriculture Department or the Interior Department, and irrespective of the nominal objectives of the program, so long as the requisite environmental purposes are in fact served.

Explanation of Provision

The bill provides that the requisite certification under this provision may also be obtained from the Secretary of the Interior, where the applicable program is administered by the Interior Department. In addition, the bill provides that the fact that the stated purpose of a state program is to promote public health and safety will not preclude a determination that payments under such program qualify under this provision.

Effective Date

The provision is effective for payments after September 30, 1979, in all open tax years.

II. Capital Cost Provisions (Sec. 6662 of the Bill)

A. Depreciation and Investment Tax Credit

1. Depreciation provisions

a. Effect of depreciation on earnings and profits of foreign corporations (sec. 6662(a)(3) of the bill, sec. 201(b) of the Reform Act, and sec. 312(k)(4) of the Code)

Present Law

The Act requires the use of an alternative depreciation system in determining the earnings and profits of a corporation. Under this system, depreciation allowances are computed using the straight line method (without regard to salvage value) and a recovery period that generally equals the property's class life.

Explanation of Provision

The bill clarifies that the alternative depreciation system applies in determining the earnings and profits of all foreign corporations.

b. Mid-quarter convention (secs. 6662(a)(5) and 6662(c)(2) of the bill, secs. 201(a) and 203(d) of the Reform Act, and sec. 168(d)(3) of the Code)

Present Law

If the aggregate depreciable bases of property that is placed in service during the last three months of any taxable year exceed 40 percent of the aggregate depreciable bases of all property that is placed in service during the entire taxable year, then a mid-quarter convention applies to the property that is placed in service during that taxable year. For purposes of the 40-percent limitation, all the members of an affiliated group (within the meaning of sec. 1504 including the rules of sec. 1504 (b)) are treated as one taxpayer.

Under the mid-quarter convention, property that is placed in service during any quarter of a taxable year (or disposed of during any quarter of a taxable year) is treated as placed in service (or disposed of) on the mid-point of the quarter. The mid-quarter convention applies only to property that is subject to the accelerated cost recovery system as modified by the Act ("modified ACRS").

Explanation of Provision

The bill provides that in determining whether the 40-percent limitation has been exceeded for any taxable year, property that is not subject to the revised depreciation system (i.e., property that would be subject to modified ACRS but for the application of the general effective date or a transitional rule) is taken into account only in applying the limit for taxable years that begin before October 1, 1987. Property that is subject to the revised depreciation system, but the cost is not recovered under modified ACRS because of an exception contained in section 168 (e.g., property that is placed in service in a churning transaction or property depreciated under a unit-of-production or income forecast method), is never taken into account in determining whether the mid-quarter convention applies. Property that is placed in service and disposed of within the same taxable year is disregarded for purposes of making the 40 percent determination. In applying the 40-percent test, depreciable basis is to be used rather than cost or any other measure of property placed in service.

c. Certain property placed in service in churning transactions (sec. 6662(a)(6) of the bill, sec. 201(a) of the Reform Act and sec. 168(f)(5) of the Code)

Present Law

The Act prescribes rules to prevent taxpayers from bringing certain property placed in service after December 31, 1980, under modified ACRS, where the result would be to qualify such property for more generous depreciation.

Explanation of Provision

The bill clarifies that the determination of whether property would qualify for more generous depreciation is made by comparing depreciation deductions for the first taxable year (whether a short year or a full year), assuming a half-year convention.

Further, the anti-churning rule is inapplicable to property to which modified ACRS applied in the hands of the transferor.

Finally, with respect to property that is subject to the anti-churning rule, the transferee is subject to the same depreciation regime that the transferor used. Thus, for property that was placed in service by the transferor before January 1, 1981, the transferee would use pre-1981 depreciation rules. Similarly, for property that was subject to ACRS (before amendment by the Act) in the hands of the transferor, the transferee would use pre-1987 ACRS.

d. Treatment of certain transferees (sec. 6662(a)(7) of the bill, sec. 201(a) of the Reform Act, and sec. 168(i)(7) of the Code)

Present Law

In certain cases, the transferee of property is treated as the transferor for purposes of computing depreciation deductions with respect to much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor.

Explanation of Provision

The bill clarifies that in any case where ACRS, as in effect before enactment of the Act, applied to property in the hands of the transferor, the transferee will use pre-enactment ACRS for purposes of computing depreciation deductions.

The bill clarifies that the "step in the shoes" rule applies to transactions between members of an affiliated group of corporations filing a consolidated return. In addition, the Act was not intended to apply to a mere change in form of ownership not involving a sale or exchange. For example, the change from ownership as tenants-in-common to condominium ownership not involving percentage ownership would not require the owners to begin depreciating the property over a new period.

The bill deletes the exception for transactions to which the anti-churning rule applies.

e. Exception for certain property subject to U.S. tax and used by foreign persons (sec. 6662(a)(8) of the bill, sec. 201(a) of the Reform Act, and sec. 168(h)(2)(B) of the Code)

Present Law

The Act provides that modified ACRS is inapplicable to motion picture films, video tapes, and sound recordings. The tax-exempt entity leasing rules contain an exception for foreign persons with respect to this property.

Explanation of Provision

The bill deletes the tax-exempt entity leasing exception for motion picture films, video tapes, and sound recordings. The bill also repeals related rules that applied for purposes of the investment tax credit.

f. Applicable depreciation method (sec. 6662(a)(11) of the bill, sec. 201(a) of the Reform Act, and secs. 168(b) and (c) of the Code)

Present Law

The Act permits taxpayers to elect to apply the alternative depreciation system to any class of property for any taxable year. Generally, the alternative depreciation system requires use of the straight-line method over a recovery period equal to property's present class life. For purposes of the depreciation preference under the alternative minimum tax, the cost of property generally is recovered using the 150-percent declining balance method over the present class life.

Explanation of Provision

The bill permits taxpayers to elect for regular tax purposes the depreciation rules that apply for alternative minimum tax purposes (i.e., 150-percent declining balance method over the class life).

g. Election to expense certain depreciable business assets (secs. 6662 (b)(1) and (c)(8) of the bill, sec. 201(d) of the Reform Act, and sec. 179 of the Code)

Present Law

The Act modified the provision under which a taxpayer may elect to treat the cost of qualifying property as an expense that is not chargeable to capital account. The costs for which the election is made are allowed as a deduction for the taxable year in which the qualifying property is placed in service, subject to a $10,000 limitation each year ($5,000 for a married individual filing a separate return). The amount eligible to be expensed is limited for any taxable year in which the aggregate cost of qualifying property placed in service exceeds $200,000; for every dollar of investment in excess of $200,000, the $10,000 ceiling is reduced by $1. In addition, the amount eligible to be expensed is limited to the taxable income derived from active trades or businesses. Costs that are disallowed because of the limitation based on taxable income are carried forward to the succeeding taxable year. These modifications apply to property placed in service after December 31, 1986, in taxable years ending after that date.

Explanation of Provision

The bill clarifies that costs that are disallowed because of the limitation based on taxable income may be carried forward to an unlimited number of years. Also, the deduction of costs that are carried forward is limited by the $10,000 ceiling (subject to any reduction due to investments that exceed $200,00) in every taxable year.

The bill also clarifies the application of the expensing limitations for taxable years (other than a calendar year) that include January 1, 1987. First, the cost of any qualifying property that is placed in service before January 1, 1987, and that is expensed under the law in effect before the effective date of the amendments made by the Act reduces the amount of qualifying property that is eligible to be expensed under the Act. For example, if a fiscal year taxpayer elects to expense $4,000 of qualifying property that is placed in service before January 1, 1987, then the maximum amount of qualifying property placed in service during the same taxable year and on or after January 1, 1987, that is eligible to be expensed is $6,000.

Second, all qualifying property that is placed in service during a fiscal year that includes January 1, 1987, is to be taken into account in determining whether the $200,000 limitation has been exceeded for such fiscal year. If the $200,000 limitation has been exceeded for a fiscal year that includes January 1, 1987, only the amount of property placed in service during the same taxable year and on or after January 1, 1987, that is eligible to be expensed would be reduced by the excess. Finally, the taxable income derived from an active trade or business for purposes of the taxable income limitation equals the taxable income for the entire fiscal year reduced by the cost of property that was expensed for that year under the law in effect before the effective date of the amendments made by the Act.

h. Effective dates; transitional rules (secs. 6662 (c) and (d) of the bill and secs. 203 and 204 of the Reform Act)

Present Law

The Act modified ACRS for property placed in service after December 31, 1986. The Act provided an election to apply modified ACRS to certain property placed in service after July 31, 1986. Such an election disqualified property under the investment tax credit transitional rules, which are discussed below.

The Act provides certain exceptions to the general effective date. Under these exceptions, transition property generally must be placed in service by a prescribed date that is determined by reference to the ADR midpoint for the property. Property that is described in a transition rule contained in section 204(a) of the Act is treated as having an ADR midpoint of 20 years and, thus, generally must be placed in service before January 1, 1991.

Explanation of Provisions

The bill clarifies that the election to apply modified ACRS to property placed in service after July 31, 1986, is unavailable to property that would be subject to the anti-churning rule if such property was placed in service after December 31, 1986.

The bill also clarifies that the transitional rule for sale-leasebacks applies to property that would have qualified for transitional relief in the absence of the sale-leaseback (e.g., property that is not placed in service by the original owner before the sale-leaseback) and to property where the original owner is a sublessee if all the other requirements for transitional relief are satisfied.

The bill also clarifies that modified ACRS applies to any real property, including personal residence, that was acquired before January 1, 1987, and converted from personal use on or after such date to a use for which depreciation is allowable.

For purposes of the general transitional rules, all members of the same affiliated group of corporations (within the meaning of section 1504 of the Code) filing a consolidated return are treated as one taxpayer.

For purposes of the binding contract rule, a purchase order will be treated as a binding contract even if not captioned as such, provided it is an order under a supply agreement for a specific number of properties based on the pricing provisions of the supply agreement. Clauses specifying settlement charges and adjustment charges to be paid by a buyer who buys less than a minimum quantity of items under a volume supply agreement are not liquidated damages clauses unless the volume supply agreement defines them as the sole remedy of the seller and the sole liability of the buyer.

The bill makes other clarifying amendments to transitional rules of more limited application, including—but not limited to—clarifications that (1) the general rule for property financed with tax-exempt bonds does not override more specific transitional rules (such as the transitional rule for solid waste disposal facilities); and

(2) the rule for finance leases of farm equipment incorporates the amendments made by the Tax Reform Act of 1984.

2. Investment tax credit

a. Termination of regular percentage (sec. 6662(e) of the bill, sec. 211 of the Reform Act, and sec. 49 of the Code)

Present Law

For purposes of determining the amount of the investment tax credit ("ITC"), the regular percentage does not apply to property placed in service after December 31, 1985, subject to an exception for transition property. A taxpayer is required to reduce the basis of property that qualifies for transition relief ("transition property") by the full amount of ITC earned. Further, the ITCs allowable for transition property for taxable years beginning after June 30, 1987, and carryforwards to the first taxable year beginning after June 30, 1987, is reduced by 35 percent. For taxpayers with a taxable year that straddles July 1, 1987, ITCs are subject to a partial reduction that reflects the appropriate reduction for the portion of the taxable year after that date.[1] In the case of transition property that was subject to a full basis adjustment in respect of ITCs earned but unused, there is no upward basis adjustment if the ITCs are subject to further reduction when carried forward.

Explanation of Provision

The bill clarifies that a full basis adjustment is applied only with respect to the portion of an ITC attributable to the regular percentage. Further, if a credit for which a full basis adjustment was required (1) is recaptured, there will be an upward basis adjustment of 100 percent of the recapture amount, or (2) expires at the end of the carryforward period, a deduction will be allowed for 100 percent of the unused credit. Also, in applying the rule that coordinates the election to pass an ITC to a lessee and the basis adjustment, the required income inclusion is equal to 100 percent of the credit allowed to the lessee.

The bill also clarifies that the 35-percent reduction applies to ITC carryforwards used in a taxable year ending after June 30, 1987, irrespective of when the property with respect to which the credit is claimed was placed in service. For taxable years that straddle July 1, 1987, the bill clarifies that the amount added to carryforwards bears the same ratio to the carryforwards from the taxable year (before inclusion of the additional amount) as the reduction of the credit bears to the sum of the current year credit for the taxable year and the carryforwards to the taxable year, less the reduction of the credit under section 49(c)(3).

The bill clarifies that the order in which the components of the general business credit and the subcomponents of the investment tax credit are used generally is the order in which the credits are listed in the applicable Code section as of the close of the taxable year in which the credit is used.

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[1] In the case of a corporation that is included in a consolidated return, the determination of whether the taxable year straddles July 1, 1987, is to be made by reference to the taxable year of the consolidated group, and not by reference to any short taxable year applicable to a corporation that is sold out of the group or a corporation that joins the group.

The bill also makes clarifying amendments to transition rules of limited application.

b. Elective 15-year carryback for steel companies and qualified farmers (sec. 6662(f) of the bill and secs. 212 and 213 of the Reform Act)

Present Law

Certain steel companies can elect a 15-year carryback of 50 percent of ITC carryforwards in existence as of the beginning of a taxpayer's first taxable year beginning after December 31, 1985. The amount claimed as a payment against the tax for the first taxable year beginning on or after January 1, 1987, may not exceed the taxpayer's net tax liability for all taxable years during the carryback period (not including minimum tax liability, and reduced by the sum of certain allowable credits).

The amount of ITC carryforwards that are taken into account in determining the amount treated as a payment of tax is not taken into account under section 38 for any other taxable year. For example, if the available ITC carryforwards are $100,000 and the net tax liability during the carryback period is $40,000, then the amount of ITC carryforwards available for future taxable years would equal $20,000.

In the case of an electing corporation that is a member of an affiliated group of corporations that filed a consolidated tax return during any portion of the carryback period, the Act contemplates that the Internal Revenue Service will reduce the administrative burden of complying with this requirement—for example, by permitting the use of pro forma statements.

Explanation of Provisions

The bill provides that rules similar to the rules of section 6425 shall apply to any overpayment resulting from the application of the provision for the elective 15-year carryback. In addition, the bill provides that any restructuring of a qualifying steel company does not affect the amount of the benefit that would otherwise be available to the company. Other conforming and technical changes are made.

B. Rapid Amortization Provisions

1. Trademark and trade name expenditures (sec 6662(i) of the bill, sec. 241 of the Reform Act, and sec. 167 of the Code)

Present Law

The Act repealed the prior law provision that allowed taxpayers to elect to amortize over a period of at least 60 months expenditures for the acquisition, protection, expansion, registration or defense of a trademark or trade name other than an expenditure which was part of the consideration for an existing trademark or tradename.

No amortization or depreciation deduction is intended to be allowed for trademark or trade name expenditures.

Explanation of Provision

The bill clarifies that no depreciation or amortization deduction is allowable for trademark or trade name expenditures.

2. Railroad grading or tunnel bores (sec. 6662(i) of the bill, sec. 242 of the Reform Act, and sec. 167 of the Code)

Present Law

The Act repealed the prior law provision which provided an election to amortize the cost of qualified railroad grading and tunnel bores over a 50 year period.

No amortization or depreciation deduction is intended to be allowed for such expenditures.

Explanation of Provision

The bill clarifies that no amortization or depreciation deduction is allowable with respect to railroad grading or tunnel bores.

C. Real Estate Provisions

1. Tax credit for rehabilitation expenditures (sec. 6662(k) of the bill and sec. 251 of the Reform Act)

Present Law

The Act modified the rehabilitation credit generally for property placed in service after December 31, 1986. Exceptions were provided under transitional rules.

Explanation of Provisions

The bill clarifies that a rehabilitation need not be completed pursuant to a written contract that was binding on March 1, 1986, under the transitional rule that applies where property was acquired before March 2, 1986, or after that date pursuant to a written contract, and either (1) the required parts of the Historic Preservation Certification Application were filed, or (2) the lesser of $1 million or five percent of the qualified rehabilitation expenditures were incurred or required to be incurred before that date.

Under a provision included in the capital cost recovery section (discussed above), the bill clarifies that property eligible for a 25-percent credit under a transitional rule is not subject to the full basis adjustment requirement.

The bill also includes amendments with respect to other transitional rules of more limited application.

2. Tax credit for low-income rental housing (sec. 6662(1) of the bill, sec. 2552 of the Reform Act, and sec. 42 of the Code)

Present Law

The Act provides a tax credit that may be claimed by owners of residential rental property used for low-income housing. The credit is claimed annually, generally for a period of ten years beginning either with the year a building is placed in service or one year thereafter (the credit period). Special rules apply to multiple building projects and for certain subsequent additions to basis.

New construction and rehabilitation expenditures for low-income housing projects placed in service in 1987 are eligible for a maximum nine percent credit, claimed annually for ten years. The acquisition cost of existing buildings and the cost of newly constructed buildings receiving other Federal subsidies (e.g., tax-exempt bond financing) placed in service in 1987 are eligible for a maximum four percent credit, also claimed annually for ten years. For buildings, placed in service after 1987, these credit percentages will be adjusted to maintain a present value of 70 percent and 30 percent for the two types of credits, and will be determined monthly for property placed in service in each month.

To qualify, a low-income housing project must satisfy a low-income set-aside requirement of either (1) 20 percent of the units occupied by persons having incomes of 50 percent or less of area median income, or (2) 40 percent of the units occupied by persons having incomes of 60 percent or less of such area income. A special additional requirement applies to projects satisfying a specified rent-skewing requirement.

The credit amount is based on the qualified basis of the housing units serving the low-income tenants. Qualified basis is the portion of the basis of the building (eligible basis) attributabnle to low-income housing units. Basis of units whose cost is disproportionate to that of the low-income housing units is excluded from eligible basis.

Rents that may be charged families in units on which a credit is claimed may not exceed 30 percent of the applicable income qualified as "low", adjusted for family size. Section 8 payments are excluded in determining the amount of rent a tenant pays for purposes of this 30-percent limit.

To qualify for the credit, residential rental property must comply continuously with all requirements of the credit throughout a 15-year compliance period,[2] and, in the case of a credit for acquisition, may not have previously been placed in service for at least 10 years (the 10-year rule). A credit allocation from the appropriate State credit authority must be received by the owner of property eligible for the low-income housing tax credit, unless the property is substantially financed with the proceeds of tax-exempt bonds subject to the new private activity bond volume limitation. Allocations are charged against the issuer's credit authority for the year of the allocation. Carryforwards of unused credit authority are not permitted.

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[2] Failure to satisfy this 15-year compliance period results in recapture of a portion of the credit. (A special rule for determining if a dispositon is a recapture event applies to projects owned by certain large partnerships.)

Explanation of Provisions

Election to determine credit percentage early

The bill provides that, in addition to the method of determining the credit percentage under present law, for buildings placed in service by a taxpayer after 1987 the taxpayer (with the consent of the housing credit agency) may irrevocably elect to determine the credit percentage applicable to the building in advance of the building's place-in-service date. Such an election will be binding for Federal income tax purposes on the taxpayer, the credit agency, and all successors in interest. The election must be made at the time a binding commitment is received by the taxpayer from the credit agency as to the housing credit dollar amount to allocated to the building. In the case of a building financed with the proceeds of tax-exempt bonds for which no allocation from a credit agency is required, the election must be made by the taxpayer at the time the tax-exempt bonds are issued. The election must be filed with the Treasury Department by the fifth day of the month following the date the binding commitment is made or the bonds are issued. This election is applicable to credits attributable to new construction, rehabilitation, and acquisition expenditures.

Determination of gross rent

The bill provides that in determining the gross rent that may be paid by a tenant in a low-income unit, payments of State and local rental assistance programs comparable to section 8 of the United States Housing Act of 1937 are not considered. The bill further provides that this definition of gross rent is used for purposes of determining the rent that may be charged to a low-income tenant when applying the elective deep-rent skewing set-aside requirement for certain projects (*see* sec. 142(d)(4)). (The bill retains the definition of gross rent, which includes all rental assistance payments, used in the determintion of the 3:1 rent skewing test also provided for those projects.)

The bill further provides that if a Federal rental assistance payment is made with respect to a low-income unit and the Federal statute (as in effect on October 22, 1986) governing that assistance payment requires that the gross rent paid by the occupants for that unit increase as the income of the occupants increases and that any such increase in the occupants' gross rent reduce equally the Federal rental assistance payment, then the gross rent paid by the tenant may exceed 30 percent of the applicable income limit to the extent required under the applicable Federal housing program statute.

Special rules for multiple building projects

The bill provides new rules for determining whether a building is part of a qualified low-income housing project in the case of multiple building projects. In such a project, buildings need not meet the minimum low-income set-aside requirement only by reference to the order that the buildings are placed in service. If within 12 months of the placed-in-service date of a prior building the project meets the set-aside requirement with respect to the first building and any subsequent buildings placed in service within the 12-

month period, then the first building and included subsequent buildings are part of a qualified low-income project. Subsequent buildings are included in determining whether the project satisfies the set-aside requirement with respect to prior buildings have their own 12-month period before they are qualified to be included in the set-aside determination for the project.

De minimis exception to disproportionate cost limit

The bill permits a portion of the basis of housing units whose cost is disproportionate to that of the low-income units to be included in eligible basis. Unless otherwise provided by Treasury regulations, to be eligible for this exception, the cost per square foot of the disproportionate unit may not exceed by 15 percent the average cost per square foot of the low-income units. If cost differentials exceed 15 percent, the cost of the entire disproportionate unit must be excluded from eligible basis, as under present law.

The bill further provides that costs with respect to which an election was made by the taxpayer to deduct rehabilitation expenditures under prior law section 167(k) may not be included in eligile basis.

Exceptions to 10-year rule

The bill provides several exceptions to the restriction that buildings eligible for an acquisition credit may not have been previously placed in service within 10 years of the date of acquisition. Under these exceptions, a placement in service is disregarded if it is as a result of (1) death, (2) acquisition by a governmental unit or certain qualified 501(c)(3) or 501(c)(4) organizations whose acquisition of the property was at least 10 years after it was previously placed in service, or (3) a foreclosure occurring at least 10 years after the previous place-in-service date, provided the property is resold within 12 months of such foreclosure.

Amendments affecting State credit authority

The bill provides that the State low-income housing credit authority must allocate credits to a building in the calendar year it is placed in service, unless (1) credits are allocated as the result of additions to qualified basis or (2) the authority makes a binding commitment no later than the last day of such year to allocate a specified amount of credits to the building in a later year. An allocation in a later calendar year pursuant to a binding commitment is counted against the State's credit authority limitation in such later year. Such later allocation does not defer the start of the credit period or the compliance period.

The bill further provides that, if for reasons unforeseen and beyond the control of the taxpayer which occur after an allocation of credit authority to a building, a building cannot be placed in service in the year for which an allocation was made, then upon approval by the Treasury Department, the credit allocation will be valid for that building if the building is placed in service in the first succeeding year after the year of the original allocation. This provision is effective beginning in 1988.

The committee intends that the Treasury Department use the authority granted by this amendment to permit carryover of credit allocations in a manner that recognizes the realities of rental housing development. Accordingly, to the extent that they do not represent nonaction or actions traceable to the developer to create circumstances warranting a carryover, carryover might be permitted in the case of labor strikes or slowdowns; breach of contract by contractors or subcontractors; commencement of significant litigation against a project; delays in obtaining construction or permanent financing, zoning, bonding, or environmental permits; or unanticipated weather conditions causing construction delays. For such circumstances to justify a carryover of a credit allocation, they must occur or must be continuing subsequent to granting of a binding allocation of State credit cap for the project and either (a) the obtaining of a commitment for permanent financing (the issuance of bonds in the case of tax-exempt bond financed projects) or receipt of an FHA Firm Commitment, or (b) commencement of construction in anticipation of use of the credit.

The bill provides that if a corporation is wholly owned by one or more qualified nonprofit organizations and such corporation materially participates in the development and operation of a qualified low-income project, the qualified nonprofit organization(s) will be treated as materially participating in the development and operation of such project for purposes of this section.

Recapture

The bill makes modifications to the rules regarding recapture of the credit. First, the bill provides that there will be no recapture for certain *de minimis* changes in the qualified basis by reason of changes in floor space of low-income housing units. Second, for partnerships more than 50 percent of which are owned by 35 or more natural persons or estates, the presence of a corporate partner will not exclude the partnership from a special rule under which recapture is determined at the partnership, rather than the partner, level.

Other amendments

The bill clarifies that, similar to other Federally subsidized loans, the proceeds of an issue of tax-exempt obligations used to finance a building may be excluded from eligible basis and the building will not be treated as federally subsidized.

The bill provides that tax-exempt financing or a below market loan used to provide construction financing for a building will not be treated as a Federal subsidy if such loan is repaid and any underlying obligation (e.g., tax-exempt bond) is redeemed before the building is placed in service.

The bill modifies the at-risk provisions applicable to certain financing from qualified nonprofit organizations in the case of certain federally assisted buildings in which a security interest is not permitted by a Federal agency.

The bill provides certain information reporting requirements on owners of qualified low-income housing projects and imposes a penalty for failure to provide required information.

The bill clarifies that the sunset of credit authority to buildings placed in service after 1990 also applies to buildings financed with the proceeds of tax-exempt bonds not requiring an allocation of credit authority.

The bill provides that credits may not be carried back to taxable years ending before January 1, 1987.

The bill makes clarifying amendments to certain transitional rules of limited application.

The bill also corrects other minor clerical and technical errors.

III. Capital Gains and Losses (Sec. 6663 of the Bill)

1. Individual and corporate capital gains (sec. 6663(a)-(c) of the bill, secs. 301-311 of the Reform Act, and various secs. of the Code)

Present Law

The Act repealed the prior law capital gains deduction for individuals and repealed the alternative tax rate on capital gains for corporations.

Explanation of Provision

The bill makes several conforming amendments to the repeal of the special capital gains treatment, including amendments relating to the computation of foreign source capital gain net income (sec. 904), the exclusion of capital gains by certain financial institutions in computing bad debt reserves under the taxable income method (sec. 593(b)), and the effective date for certain withholding changes. Further, the bill authorizes the Secretary to lower the withholding rate on gains from certain dispositions of U.S. real property interests by U.S. partnerships, trusts, or estates from 34 percent of the gain realized to 28 percent of the gain realized. The committee expects that the Secretary will exercise this authority when the partner or beneficiary who is the taxpayer with respect to such gain is a foreign individual.

The bill also repeals a transitional rule for specified taxpayers.

2. Incentive stock options (sec. 6663(d) of the bill, sec. 321 of the Reform Act, and sec. 422A of the Code)

Present Law

Under present law, generally an employee is not taxed on the grant or exercise of an incentive stock option (as defined in section 422A(b)) and the employer is not allowed a deduction when the option is granted or exercised. The Act made several changes in the definition of an incentive stock option, including a change to provide that under the terms of the plan, the aggregate fair market value (at the time of grant of an option) of the stock with respect to which incentive stock options are first exercisable during any calendar year may not exceed $100,000.

Explanation of Provision

The bill provides that an option shall not be treated as an incentive stock option if, at the time the option is granted, the terms of the option provide that it will not be treated as an incentive stock option. Thus, an option that otherwise satisfies the requirements of section 422A(b) shall not be treated as an incentive stock option if, at the time of grant, the option is designated as not constituting an incentive stock option. In the case of an option granted after December 31, 1986, and before the date of enactment of this bill, an option will not be treated as an incentive stock option if the terms of the option are so amended before 90 days after the enactment of this bill.

The bill also deletes the $100,000 requirement added by the Act and instead provides that to the extent that aggregate fair market value (determined at the time the option is granted) of stock with respect to which options meeting the requirements of section 422A(b) are exercisable for the first time by any individual during any calendar year (under all plans of the individual's employer corporation and its parent and subsidiary corporations) exceeds $100,000, then such options shall not be treated as incentive stock options. This rule is applied by taking options that meet the requirements of section 422A(b) and are exercisable for the first time in the calendar year into account in the order granted.

IV. Agriculture and Natural Resource Provisions (Sec. 6664 of the Bill)

1. Treatment of discharge of indebtedness income of certain farmers (sec. 6664(a) of the bill, sec. 405 of the Reform Act, and secs. 108 and 1017 of the Code)

Present Law

Under present law, if an insolvent taxpayer realizes income from discharge of indebtedness, the income is excluded and the taxpayer's tax attributes and basis in property are reduced by the excluded amount (sec. 108). The exclusion is limited to the amount by which the taxpayer is insolvent. Reduction of attributes and basis occurs in the following order: net operating losses and carryovers, general business credit, carryovers, capital loss carryovers, basis of property, and foreign tax credit carryovers.[1] The reduction in the basis of property is limited to the excess of the aggregate bases of the taxpayer's property over the taxpayer's aggregate liabilities immediately after the discharge (sec. 1017). If the taxpayer's discharge of indebtedness income (not in excess of the amount by which the taxpayer is insolvent) exceeds the available tax attributes and basis, the excess is forgiven, i.e., is not includible in income.

The Act provides that, in the case of a solvent taxpayer who realizes income from the discharge by a "qualified person" of "qualified farm indebtedness," the discharge is treated in the same manner as if incurred while the taxpayer was insolvent. Qualified farm indebtedness is indebtedness incurred directly in connection with the operation of a farming business by a taxpayer who satisfies a specified gross receipts test. The gross receipts test is satisfied if 50 percent or more of the taxpayer's average annual gross receipts for the three taxable years preceding the taxable year in which the discharged indebtedness occurs is attributable to the trade or business of farming. A qualified person is one regularly engaged in the business of lending money and meeting certain other requirements.

Any amount excluded from income under the special rules for qualified farm indebtedness must be used first to reduce tax attributes; then to reduce basis of property other than land used or held for use in a farming business; and finally to reduce the basis of land used or held for use in a farming business (sec. 1017).

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[1] An election is provided under which the taxpayer may reduce basis in depreciable property before reducing net operating losses or other attributes.

Explanation of Provision

The bill clarifies that, for purposes of determining whether a taxpayer's indebtedness is qualified farm indebtedness, the gross receipts test is applied by dividing the taxpayer's aggregate gross receipts from farming for the three-taxable-year period preceding the taxable year of the discharge by the taxpayer's aggregate gross receipts from all sources for that period. In addition, the term "qualified person" is modified to include a Federal, State, or local government or agency or instrumentality thereof.

The bill provides that, after reducing tax attributes in the order prescribed for insolvent taxpayers, amounts excluded from income under the qualified farm indebtedness provision may be applied to reduce basis in assets used or held for use in a trade or business or for the production of income (i.e., in "qualified property"). Basis reduction occurs first with respect to depreciable property, then with respect to land used in the business of farming, and then with respect to other qualified property.

The amount excluded under this provision may not exceed the taxpayer's total available attributes and basis in qualified property. Accordingly, to the extent there is unabsorbed discharged of indebtedness income after the taxpayer has reduced tax attributes and basis in qualified property, income will be recognized.

2. Retention of capital gains treatment for sales of dairy cattle under milk production termination program (sec. 6664(b) of the bill and sec. 406 of the Reform Act)

Present Law

The act generally repealed the prior-law deduction for 60 percent of long-term capital gains of noncorporate taxpayers and the alternative tax for long-term capital gains of corporations. However, these amendments made by the Act do not apply to any gain from the sale of dairy cattle under a valid contract with the United States Department of Agriculture under the milk production termination program to the extent such gain is properly taken into account under the taxpayer's method of accounting after January 1, 1987 and before September 1, 1987.

Explanation of Provision

The bill clarifies that the amendments made by the Act with respect to capital gains do not apply to gain properly taken into account under the taxpayer's method of accounting on or after January 1, 1987, and before October 1, 1987, (rather than after January 1, 1987 and before September 1, 1987).

The transition provision applies only to gains that would be capital gains under the generally applicable provisions of the law. See, e.g., IRS Notice 87-26, 1987-10 IRB 16. (February 26, 1987). The transition provision does not recharacterize any payments that would not otherwise be capital gains.

3. Recapture of mining exploration expenses (sec. 6664(c) of the bill, sec. 1254 of the Code and sec. 413 of the reform Act)

Present Law

The Act provided that on the disposition of a mining property, the amounts deducted for mining development and exploration expenses are recaptured as ordinary income.

Explanation of Provision

The bill clarifies that the expensed mining exploration expenses that are included in income upon reaching the producing stage are not recaptured.

V. Tax Shelters; Interest Expense (Sec. 6665 of the Bill)

1. Passive loss rules (sec. 6665(a) of the bill, sec. 501 of the Reform Act, and sec. 469 of the Code)

Present Law

Present law, as amended by the Reform Act, provides that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income. Similarly, credits from passive activities generally are limited to the tax attributable to the passive activities. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next year. Suspended losses (but not credits) are allowed in full when the taxpayer disposes of his entire interest in the activity to an unrelated party in a transaction in which all realized gain or loss is recognized.

The provision applies to individuals, estates, trusts, and personal service corporations. A special rule prohibits the use of passive activity losses and credits against portfolio income in the case of closely held corporations. Losses and credits attributable to a limited partnership interest generally are treated as arising from a passive activity (except as provided in regulations). Rental activities are defined as passive activities. Special rules provide that up to $25,000 of losses and (deduction equivalent) credits from rental real estate activities (those in which the taxpayer actively participates, with an exception for certain credits) are allowed against other income for the year. Losses from certain working interests in oil and gas property are not limited by the provision. The provision is effective for taxable years beginning after 1986. For certain pre-enactment interests in passive activities, the provision is phased in, and becomes fully effective for taxable years beginning in 1991 and thereafter.

Explanation of Provisions

Definition of portfolio income.—The bill clarifies that income not treated as from a passive activity includes gain or loss that is not derived in the ordinary course of a trade or business, in the case of a disposition of property held for investment or property that generally produces income in the nature of interest, dividends, annuities or royalties. Gain or loss upon disposition of such property, where the gain or loss is derived in the ordinary course of a trade or business, is not automatically treated as not from a passive activity under this rule; rather, the general rules applicable to determining whether an activity is passive (e.g., whether the taxpayer materially participates) apply.

Dispositions.—The bill restates the rules applicable to the allowance of suspended losses upon a disposition of an interest in a passive activity.

In addition, the bill provides that, pursuant to regulations, to the extent necessary to prevent avoidance of the provision, income or gain from a passive activity in taxable years preceding the taxpayer's disposition of the activity is taken into account in determining the amount of the loss allowed against non-passive income upon disposition. Regulatory authority might appropriately be exercised, for example, in situations where passive activities produce taxable passive income in the initial years of an investment and then a loss upon disposition, such as where the investment is structured so that income is recognized in years prior to the allowance of related deductions.

The bill also makes several clerical amendments to the provisions relating to dispositions.

Special rule for rental real estate activities.—The bill clarifies the application of the active participation requirement for the allowance of up to $25,000 of losses (or deduction equivalent credits, where applicable) from certain rental real estate activities. The bill provides that the active participation requirement applies both in the year when the loss arose, and in the year when the loss is allowed under the $25,000 allowance. (The active participation requirement does not apply to low income housing or rehabilitation credits otherwise allowable under the $25,000 allowance.)

The bill also modifies the rule that an interest in an activity as a limited partner is not treated as an interest with respect to which the taxpayer actively participates. Under the bill, this rule applies except as otherwise provided in regulations.

The bill also clarifies that the phase-in of the passive loss rules for pre-enactment interests does not apply to losses specifically allowed under the $25,000 rule.

Coordination with rental use of dwelling.—The bill provides that income, deductions, gain or loss from rental use of a dwelling that the taxpayer uses as a residence (or from certain other business uses of a dwelling), for any taxable year in which deductions from such use are limited to the amount of income from such use under Code sec. 280A(c)(5), are not taken into account in determining the taxpayer's passive activity loss for the year. This provision eliminates the partial overlap of the deduction limitations imposed by sec. 280A(c)(5) and by the passive loss rules, principally in the circumstance of rental use of residences, and thus tends to simplify the application of these rules.

Affiliated groups.—The bill clarifies that for purposes of the passive loss rule, all members of an affiliated group that files a consolidated tax return are treated as one corporation, except as otherwise provided in regulations.

Trusts and estates.—The bill provides that if a trust or estate distributes its entire interest in a passive activity to the beneficiary of the trust or estate, the basis of the property immediately before the distribution shall be increased by the amount of the passive activity losses allocable to the activity. Gain or loss to the trust or estate and the basis of the property in the hands of the beneficiary will then be determined under the usual rules applicable under the Code.

Certain installment sales.—The bill treats as income from a passive activity, gain that is recognized in a taxable year beginning after 1986 from the disposition (in a taxable year beginning before 1987) of an interest in an activity that would have been treated as a passive activity within the meaning of section 469. Thus, under the bill, income from passive activities includes post-1986 gain from the pre-1987 installment sale of an activity that the taxpayer can show would be treated as a passive activity if the passive loss rule had applied in the year of disposition.

The bill also makes clerical amendments to the definition provisions of the passive loss rule.

2. At-risk (sec. 503 of the Reform Act and sec. 465 of the Code)

Present Law

The Act made real estate activities subject to the at-risk rules, with an exception for certain financing from qualified lenders. The legislative history to that Act states that qualified persons include "banks, savings and loan associations, credit unions, insurance companies, qualified pension trusts, and other persons actively and regularly engaged in the business of lending money."

Explanation of Provision

The committee wishes to clarify that a mortgage fund in which any class of beneficial interest is registered with the Securities and Exchange Commission shall be a person which is considered for this purpose as actively and regularly engaged in the business of lending money.

3. Investment interest limitation (sec. 6665(c) of the bill, sec. 511 of the Reform Act, and sec. 163(d) of the Code)

Present Law

Under present law, in the case of noncorporate taxpayers, the deduction for investment interest expense is limited to the amount of net investment income for the year. Investment interest disallowed for the year is carried forward and treated as investment interest paid or accrued in the succeeding taxable year, and is allowable to the extent the taxpayer has net investment income in such year.

Investment interest is defined to include interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. For this purpose, property held for investment includes an interest in a trade or business activity that is treated as not a passive activity, but in which the taxpayer does not materially participate, within the meaning of the passive loss rule. Investment interest also includes interest expense properly allocable to portfolio income under the passive loss rule. Investment income is defined under present law as gross income from, and gain from the disposition of, property held for investment, to the extent such amounts are not derived from the ordinary conduct of a trade or business.

The provisions of the Reform Act affecting the investment interest limitation are phased in, so that the amended provisions become fully effective for taxable years beginning in 1991 and thereafter.

Explanation of Provisions

Investment interest .—The bill conforms the language of the definition of investment interest to the language of a related provision that allocates interest expense to protfolio income under the passive loss rule. Thus, under the bill, investment interest is that which is properly allocable to property held for investment. This change results in consistency in the language of the provisions allocating interest expense to the category of investment interest, and permits consistent application of a standard for allocation of interest. This change is not intended to sugget that the adoption of any particular method of allocation is required, but rather to give Treasury the ability to devise allocation rules as simple as possible consistent with the objectives of the provision. The committee believes that the Treasury should consider rules relating to the securing of property to mitigate some of the complexities of tracing where simplicity is desirable, so that, for example, any interest on a loan secured by personal use property could be considered personal interest, and any interest on a loan secured by investment assets could be considered investment interest.

Investment income.—The bill conforms the definition of investment income to the definition of investment interest, by deleting the provision that amounts are treated as investment income only to the extent such amounts are not derived from the conduct of a trade or business.

Transitional rules.—The bill clarifies the operation of the phase-in rule. The bill provides that the amount of current year's investment interest disallowed during any taxable year in the phase-in period shall not exceed the sum of (1) the amount that would be disallowed if: (a) the net investment income were increased by the ceiling amount (generally $10,000), (b) the reduction of net investment income by passive losses allowed under the passive loss phase-in rule did not apply, and (c) an interest in any activity that is not treated as passive and in which the taxpayer does not materially participate were not treated as held for investment; and (2) the applicable percentage for such year (e.g., 35 percent in 1987) of the amount which would be disallowed, under the fully phased-in investment interest limitation, over the amount determined under (1) above.

The bill also provides that any amount disallowed as a deduction as investment interest under prior law which would have been treated as investment interest paid or accrued in the taxpayer's first taxable year beginning after 1986 (under section 163(d)(2) of prior law) shall, to the extent attributable to a passive loss activity (e.g. interest incurred to purchase property subject to a net lease), be treated as a deduction under section 469 allocable to such activity and not as a deduction for investment interest. The passive loss phase-in rules shall not apply to such amount.

4. Personal interest limitation (sec. 6665(c) of the bill, sec. 511 of the Reform Act, and sec. 163(h) of the Code)

Present Law

Under present law, as amended by the Reform Act, personal interest is not deductible. Personal interest is any interest, other than interest incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee), investment interest, or interest taken into account in computing the taxpayer's income or loss from passive activities for the year.

Present law provides that qualified residence interest is not subject to the limitation on personal interest. Qualified residence interest is interest on debt secured by a security interest valid against a subsequent purchaser on the taxpayer's principal residence or a second residence of the taxpayer. Interest on such debt is deductible to the extent that the debt does not exceed the amount of the taxpayer's basis for the residence (including the cost of home improvements), plus the amount of qualified medical and qualified educational expenses, and to the extent the amount of the debt does not exceed the fair market value of the residence. A grandfather rule is provided in the case of debt incurred on or before August 16, 1986 and secured by the taxpayer's principal or second residence. Interest on such debt (reduced by any principal payments thereon) is generally treated as qualified residence interest, provided the amount of the debt does not exceed the fair market value of the residence. The personal interest limitation is phased in for taxable years beginning after 1986, and becomes fully effective for taxable years beginning in 1991 and thereafter.

Explanation of Provisions

Personal interest.—The bill conforms the language of the definition of personal interest to the language of related provisions (the passive loss rule and the investment interest limitation) under which interest expense may be allocated. Thus, the bill provides that personal interest does not include interest that is properly allocable to a trade or business. This change results in consistency in the language of several significant provisions under which interest is likely to be allocated, and permits consistent application of a standard for allocation of interest.

Refinancing of grandfathered debt.—The bill provides that interest on indebtedness secured by a qualified residence and incurred after August 16, 1986, to refinance grandfathered indebtedness (for example, to obtain a lower interest rate) will be treated as qualified residence interest if certain requirements are met.

Indebtedness secured by the qualified residence and incurred after August 16, 1986 to refinance pre-August 17, 1986 grandfathered indebtedness qualifies under this rule to the extent that the principal amount of the refinancing does to exceed the principal amount of the pre-August 17, 1986 grandfathered indebtedness immediately before the refinancing. The refinancing exception will cease to apply, however, after the expiration of the period of the pre-August 17, 1986 indebtedness. Thus, if the pre-August 17, 1986 indebtedness was scheduled to be repaid at the end of 1992, interest on any refinancing of that debt, to the extent not otherwise deductible, will not be deductible for any period after 1992. Where the pre-August 17, 1986 debt was not amortized over its term (e.g., a "balloon" note), interest on any otherwise qualified refinancing of that debt will be deductible for the term of the first refinancing of the pre-August 17, 1986 indebtedness (but not for more than 30 years after that refinancing). A refinancing of indebteness originally incurred after August 16, 1986 to refinance pre-August 17, 1986 grandfathered indebteness (e.g., a second refinancing of such pre-August 17, 1986 debt) can also qualify under this rule subject to these requirements.

Thus, under the provision, the current balance (taking into account all amortization of principal) of the debt secured by the taxpayer's residence and incurred on or before August 16, 1986, that was a grandfathered under the Reform Act, can be refinanced.

Use of residence.—The bill clarifies the definition of a residence of the taxpayer that is treated as a qualified residence, interest on debt secured by which may be treated as deductible qualified residence interest. Under the bill, a resident may be treated as a qualified resident even if the taxpayer does not use it as such at least 14 days a year of 10 percent of the time it is rented (whichever is greater), provided that the residence is not rented at all during the year.

Unenforceable security interest.—The bill provides that interest on a loan secured by a recorded deed of trust, mortgage or other security interest in a taxpayer's principal or second residence, in a State such as Texas where such security instrument will be rendered ineffective or the enforceability of such instrument will be otherwise restricted by State and local homestead or other debtor protection law such as the Texas homestead law, shall be treated as qualified residence interest, provided that such interest is otherwise qualified residence interest.

Transfer incident to divorce.—The bill provides that in certain circumstances involving a transfer of a qualified residence between spouses incident to a divorce or legal separation, the basis limitation on debt, interest on which may be deductible, may be increased by the amount of secured indebtedness incurred by a spouse in connection with the acquisition of the other spouse's interest in the residence. The amount of such debt may not, however, exceed the fair market value of the interest in the residence that is being acquired.

Estates and trusts.—The bill allows interest paid or accrued by a trust or estate on indebtedness secured by a qualified residence of a beneficiary of a trust or estate to be treated as "qualified residence interest". The bill also clarifies that interest payable on the estate tax deferred under prior law section 6166A is not personal interest.

In addition, the bill makes several clerical amendments to the personal interest limitation provisions.

VI. Corporate Tax Provisions (Sec. 6666 of the Bill)

A. Corporate Tax Rate (sec. 6666 of the bill, sec. 601 of the Reform Act, and sec. 15 of the Code)

Present Law

The Act revised corporate tax rates, effective for taxable years beginning on or after July 1, 1987. Under the Act, the maximum corporate tax rate under section 11 of the Code for such taxable years is 34 percent (rather than 46 percent, as under prior law). Income in taxable years that include July 1, 1987 (other than as the first date of such year) is subject to a blended rate under the rules specified in section 15 of the Code.

Certain other provisions of the Code require a determination of the maximum corporate tax rate under section 11 for a particular taxable year, for purposes other than imposing a tax by reference to such rate. Such provisions include the "high-taxed income" provisions of sections 904(d)(2)(F) and 954(b)(4) of the Code, which provide special treatment for certain income that is subject to foreign taxes exceeding the highest rate of tax under section 1 or 11 of the Code (or 90 percent of such rate, in the case of section 954).

Explanation of Provision

The bill clarifies that any reference in the income tax provisions of the Code to the highest rate of tax imposed by section 1[1] or section 11(b) of the Code (other than a provision imposing a tax by reference to such rate) shall be treated as a reference to the weighted average of the highest rates before and after the change determined on the basis of the respective portions of the taxable year before the date of change and on or after the date of the change. For example, in the case of a calendar year corporate taxpayer, the highest rate under section 11(b) for the calendar year 1987 would be 39.95% (181/365 × 46% and 184/365 × 34%).[2]

B. Dividends Received Deduction: Certain Dividends Received From a Foreign Sales Corporation (sec. 6666 of the bill, secs. 611 and 612 of the Reform Act, and sec. 245(c) of the Code)

Present Law

The Act reduced to 80 percent the prior law 85 percent deduction that generally applied to dividends received by corporations. The

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[1] The reference to section 1 of the Code has no application to the non-corporate rate changes imposed by the Act because the Act does not subject the changes under section 1 to section 15 of Code. However, if any future legislation were to impose a rate change under section 1 that is subject to section 15, the provision would apply to such change.

[2] 181 is the number of days in calendar year 1987 prior to July 1; 184 is the number of days in the calendar year 1987 on or after July 1.

Act did not affect the 100 percent dividends received deduction that applies in certain situations.

Under prior law, an 85 percent dividends received deduction was allowed to a domestic corporation for certain dividends attributable to qualified interest and carrying charges received or accrued by the payor corporation while it was a foreign sales corporation (FSC).

Explanation of Provision

The bill conforms the amount of the dividends received deduction for certain dividends attributable to qualified interest and carrying charges received or accrued by the payor corporation while it was a FSC to the general reduction, under the Act, of the 85 percent dividends received deduction to 80 percent. Accordingly, under the bill, the amount of the dividends received deduction for such dividends is reduced to 80 percent.

The bill makes certain other conforming and clerical amendments.

C. Extraordinary Dividends Received by Corporate Shareholders (sec. 6666 of the bill, sec. 614 of the Reform Act, and sec. 1059 of the Code)

Present Law

Under the Act, if a corporation receives an extraordinary dividend and has not held the stock subject to a risk of loss for a specified holding period (described below), the corporation must reduce its basis in the stock with respect to which the dividend was paid by the nontaxed portion of the dividend (i.e., the portion of the dividend eligible for the dividends received deduction). An extraordinary dividend is generally defined as one exceeding certain "threshold" amounts.

The Act provided a holding period requirement, under which basis reduction is required if the stock is not held subject to a risk of loss for more than two years before the dividend announcement date. The dividend announcement date is defined in the Act as the date on which the corporation declares, announces, or agrees to the payment of the dividend, whichever is the earliest.[3]

The Act also provided that certain distributions are treated as extraordinary dividends without regard to the recipient's holding period or the amount of the dividend. The distributions subject to this rule are any non pro-rata redemption and any redemption in partial liquidation constituting a dividend.

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[3] Although the amount of any fixed dividend on preferred stock is in a sense "announced" by the terms of the stock at the time the stock is acquired, all such fixed dividends on the stock, however long it is held, are not thus considered to be "announced or agreed to" within the 2-year period. However, the fixed dividends attributable to the first 2 years the preferred stock is held are considered "announced or agreed to" within the first two years, even though a payment date might be missed or there might otherwise be a delay in paying such dividends beyond the first 2 years to which they are attributable.

Similarly, if preferred stock provides for a cumulative dividend of a specified percentage of annual profits, the dividends attributable to the first 2 years profits are subject to the extraordinary dividends rule and basis reduction is required with respect to such dividends if the threshold percentage is exceeded, even if the dividends are not paid until the third year.

The basis reduction rules also apply in other situations that avoid the threshold amount or holding period requirements by deferring or staggering dividend payments.

The Act provided a special relief provison applicable to certain qualifying preferred dividends. Under this provision, certain dividends that would otherwise require basis reduction because the more than two-year holding period is not met, may be eligible for a reduced amount of basis reduction or no basis reduction if the stock is either held for five years or if the dividends received do not exceed the dividends "earned," based on the stock's stated rate of return. This relief provision applies only in the case of certain preferred dividends on stock which provides for fixed dividends payable at least annually, with respect to which the taxpayer's actual rate of return does not exceed 15 percent. Furthermore, relief is available only to the extent the taxpayer's actual rate of return does not exceed the stated rate of return.

The Act provided an exception under which no basis reduction is required in the case of an otherwise extraordinary dividend received with respect to stock of a corporation if: (i) the taxpayer has held the stock during the entire period such corporation was in existence, (ii) the only earnings and profits of the corporation were earnings and profits accumulated during such period, and (iii) the application of the exception is not inconsistent with the purposes of the extraordinary dividend provision.

The Act also provided an exception under which no basis reduction is required in the case of any qualifying dividend within the meaning of section 243(b)(1) of the Code. This provision was also intended to apply only where earnings and profits would directly or indirectly be solely attributable to the distributee shareholders in the case of distributions that constitute qualifying dividends within the meaning of section 243(b)(1). It was not intended that the extraordinary dividend provision duplicate any reductions in basis required under the consolidated return regulations with respect to dividend distributions (or deemed dividend distributions) between members of an affiliated group filing consolidated returns.

Explanation of Provision

The bill clarifies that the dividend announcement date, with respect to which the holding period requirement is tested, is the date on which the corporation declares, announces, or agrees to either the amount or the payment of the dividend, whichever is earliest. Thus, if the amount of a dividend is announced or agreed to within the two-year period, the fact that its payment may not have been announced or agreed to is irrelevant.

The bill clarifies that the nontaxed portion of any dividend that is a non pro-rata distribution or a partial liquidation distribution reduces basis, without regard to whether the two-year holding period requirement has been met.

The bill also clarifies the application of the special exception for dividends on stock that has been held during the entire existence of a corporation. This relief provision was intended to permit distributions without basis reduction, even through the distributions exceed the threshold percentage and are declared, announced or agreed to within the two-year holding period, only in those cases in which the earnings and profits from which the dividend is paid could not have been attributable, directly or indirectly, to any person other than the original shareholder receiving the distribution. For this purpose, earnings and profits are not considered attributable solely to such shareholder if any more than a de minimis part of such earnings and profits is derived, directly or indirectly, from any other entity in which the shareholder was not an original shareholder with an interest at least as great as such shareholder's original and continuing interest in the distributing corporation at the time of the distribution.

Thus, for example, the relief provison does not apply if any more than a de minimis part of the earnings and profits from which the dividend is paid were derived directly or indirectly from another corporation (e.g., through a dividend distribution or a transaction described in sec. 381, or a sale of assets received in a section 332 liquidation or other carryover basis transaction) in which the original shareholder did not at all times hold at least as great an interest as such shareholder's interest in the distributing corporation at the time of the distribution.

However, the fact that the distributing corporation directly or indirectly received de minimis amounts of earnings and profits from other entities (such as non-extraordinary dividends received from temporary portfolio investments of funds), would not generally be expected to preclude the application of the relief provision.

The bill clarifies that earnings and profits would be indirectly attributable to a person other than the shareholder receiving the distribution if they are attributable to transfers or distributions from any corporation that is not a "qualified corporation". A qualified corporation is one in which the shareholder receiving the dividend holds, directly or indirectly, at least as great an interest, throughout the entire existence of such corporation, as such shareholder has held throughout the period the corporation paying the dividend in question was in existence. In addition, a qualified corporation must have no earnings and profits which were earned by any person, or are attributable to gain on property which accrued during a period in which any person held such property, if the shareholder did not, throughout such corporation's or other person's existence, hold the requisite interest in such corporation or other person.

The bill similarly clarifies the exception for dividends that qualify under section 243(b)(1) of the Code, providing that such dividends do not qualify for the exception to the extent they are attributable to earnings and profits earned by a corporation during a period it was not a member of the affiliated group,[4] or allocable to gain on property which accrued during a period the corporation holding the property was not a member of the affiliated group.

The committee expects that the application of the provision to distributions between members of an affiliated group filing consolidated returns will be consistent with the principles of the exceptions relating to qualifying dividends and dividends with respect to stock which the distributee has held throughout the distributor's entire existence. The committee understands that, in most instances, the consolidated return regulations achieve results that are consistent with the purposes of the extraordinary dividend rules. For example, the regulations require a negative basis adjustment in the stock of a subsidiary to the extent the distribution represents preaffiliation earnings and profits of the subsidary. A negative adjustment is not required with respect to all dividend distributions, however.

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[4] For this purpose, amounts received from a subsidiary of the distributing corporation that are distributed during a year in which it is affiliated with the distributee, but which represent earnings realized by the subsidiary (or by another corporation, such as a lower-tier subsidiary) during a year in which the subsidiary (or other corporation) was not affiliated with the distributee, will not be considered earned by the distributing corporation during an affiliation year.

The committee recognizes that the failure of the consolidated return regulations to require a negative adjustment to stock for dividend distributions received from a member is, in some situations, consistent with the principles of the extraordinary dividend provision. it is not intended that this provision will require a basis reduction in such situations. For example, a distribution during a consolidated return year out of earnings and profits accumulated during a prior year, throughout which the distributing corporation was affiliated with the distributee but did not join the distributee's consolidated return, would not result in a reduction in the basis of the distributee's stock in the distributing corporation. Likewise, a distribution out of current year earnings to a member of the affiliated group with which the distributing corporation files a consolidated return does not cause a basis reduction under the consolidated return rules. If such earnings are not attributable to gain on property accrued during a period the corporation holding the property was not a member of the group, the result in most instances would not be inconsistent with the purposes of this provision.

However, to the extent results produced under the consolidated return regulations are inconsistent with the purposes and principles of the extraordinary dividend provision, the committee intends that a basis reduction may be required under this provision notwithstanding the fact that no reduction is mandated under the consolidated return regulations.

The bill clarifies that only fixed dividends (i.e., dividends that do not vary in amount from period to period) are eligible for the special relief provision for qualified preferred dividends.

The bill deletes section 1059(d)(5) of the Code as deadwood.

D. Special Limitations on Net Operating Loss and Other Carryforwards

1. Value of loss corporation: Special rule in the case of redemption (sec. 6666 of the bill, sec. 621(a) of the Reform Act, and sec. 382(e) of the Code)

Present Law

After a more than 50 percent change in ownership, the taxable income of a loss corporation available for offset by pre-acquisition NOL carryforwards is limited by a prescribed rate times the value of the loss corporation's stock immediately before the ownership change. Debt thus reduces value for purposes of the limitation. Under a special rule, if a redemption occurs in connection with an ownership change—either before or after—the value of the loss corporation's stock is determined after taking the redemption into account. Also, redemptions are taken into account in determining whether a loss corporation has a built-in gain or loss. Further, the Secretary is authorized to prescribe regulations providing for the treatment of corporate contractions as redemptions.

Explanation of Provision

In lieu of regulatory authority, the bill extends the statutory rules for redemptions to other corporate contractions. The rule for redemptions was intended to apply to transactions that effect similar economic results, without regard to formal differences in the structure used or the order of events by which similar consequences are achieved. Thus, for example, the fact that a transaction does not determine the treatment of the transaction under this provision. As one example, a "bootstrap" acquisition, in which aggregate corporate value is directly or indirectly reduced or burdened by debt to provide funds to the old shareholders, is subject to the provision. This includes cases in which debt used to pay the old shareholders remains an obligation of an acquisition or an affiliate, where the acquired loss corporation is directly or indirectly the source of funds for repayment of the obligation.

The bill also clarifies that if the old loss corporation is a foreign corporation, its value shall be determined taking into account only assets and liabilities treated as connected with the conduct of a trade or business in the United States.[5]

2. Definition of ownership change: Owner shift involving five-percent shareholder and equity structure change (sec. 6666 of the bill, sec. 621(a) of the Reform Act, and sec. 382(g)(4)(C) of the Code)

Present Law

An ownership change occurs if the percentage of stock in a loss corporation owned by one or more five-percent shareholders increases by more than 50 percentage points relative to the lowest percentage of such stock owned by those shareholders during a testing period. The determination whether an ownership change has occurred is made after any owner shift involving a five-percent shareholder or any equity structure shift.

An owner shift involving a five-percent shareholder is defined as any change in the respective ownership of stock in a corporation that affects the percentage of stock held by any person who holds five percent or more of stock in the corporation before or after the change. An equity structure shift is defined as any tax-free reorganization within the meaning of section 368, other than a divisive "D" or "G" reorganization or an "F" reorganization. For purposes of these definitions, all less-than-five-percent shareholders are aggregate and treated as a single five-percent shareholder.

In determining whether an equity structure shift has occurred, the rule that aggregates less-than-five-percent shareholders is applied separately with respect to each group of shareholders of each corporation that is a party to the reorganization ("segregation rule"). Except as provided in regulations, the segregation rule applies in determining whether there has been an owner shift involving a five-percent shareholder; the regulatory authority in section 382(m) augments this rule for cases that involve only a single corporation. To the extent provided in regulations, transactions in which it is feasible to identify changes in ownership involving less-than-five-percent shareholders will be treated under the rules for equity structure shifts.

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[5] This provision relating to foreign corporations applies only to ownership changes occurring after June 10, 1987 (the date of introduction of the bill).

Explanation of Provision

The bill amends section 382(g)(4)(C) to clarify that rules similar to the segregation rule apply to acquisitions by groups of less-than-five-percent shareholders through corporations as well as other entities (e.g., partnerships), and in transactions that do not constitute equity structure shifts.

The regulatory authority in section 382(g)(3)(B)—to treat transactions under the rules for equity structure shifts—does not limit the scope of section 382(g)(4)(C). Section 382(g)(4)(C), by it terms, generally causes the segregation of the less-than-five-percent shareholders of separate entities where an entity other than a single corporation is involved in a transaction. Section 382(g)(3)(B) merely provides additional authority, as does section 382(m), for cases in which only one corporation is involved.

3. Special rules for built-in gains and losses and section 338 gains (sec. 6666 of the bill, sec. 621(a) of the Reform Act, and sec. 382(h) of the Code)

Present Law

If a loss corporation has a net unrealized built-in gain, the section 382 limitation for any taxable year ending within a five-year recognition period is increased by the recognized built-in gain for the taxable year. A net unrealized built-in gain is the amount by which the fair market value of a corporation's assets exceeds the aggregate adjusted basis of those assets immediately before an ownership change. The definition of a net unrealized built-in gain is inapplicable unless the amount of new unrealized built-in gain exceeds 25 percent of the value of the corporation's assets. Also, the definition is applied without taking account of any cash, cash items, or marketable security with a value that does not substantially differ from adjusted basis.

The section 382 limitation is increased by the excess of (1) gain recognized by reason of an election under section 338, over (2) the portion of such gain taken into account in computing recognized built-in gains for a taxable year. A recognized built-in gain is any gain recognized during the recognition period on the disposition of any asset, if the corporation establishes that the asset was held immediately before the ownership change, and to the extent the gain does not exceed the excess of the asset's fair market value over the adjusted basis on such date.

If an ownership change occurs during a taxable year, the section 382 limitation does not apply to the utilization of losses against the portion of the corporation's taxable income allocable to the period before the change. For this purpose, except as provided in regulations, taxable income realized during the taxable year is allocated ratably to each day in such year. Under the allocation rule, taxable income is computed without regard to recognized built-in gains and losses.

If a corporation has a net unrealized built-in loss, built-in losses recognized within a 5-year recognition period are subject to the section 382 limitation. The Act provides that the disallowed loss is carried forward to subsequent taxable years under rules similar to the rules for the carrying forward of a net operating loss, and is subject to limitation in those years in the same manner as a pre-change loss.

Explanation of Provision

The bill clarifies that if a section 338 election is made, the section 382 limitation for the taxable year is generally increased by the lesser of (i) the amount of net unrealized built-in gain (determined as of the date of the section 382 ownership change), computed without regard to the 25-percent threshold requirement, or (ii) the gain recognized by reason of section 338. For purposes of (i), net unrealized built-in gain is reduced by any prior recognized built-in gain (that is, built-in gain recognized after the section 382 ownership change date and before the section 338 acquisition date).

Also, regarding the allocation rule for the taxable year in which an ownership change occurs, taxable income is computed without regard to recognized built-in gains to the extent such gains increased the section 382 limitation for the year, and without regard to recognized built-in losses to the extent such losses are treated as pre-change losses. That is, such gains or losses are disregarded for this purpose only to the extent they did not exceed the limitations on the total amount of recognized built-in gain or loss, as the case may be, for the year of recognition.

Finally, the bill clarifies that a recognized built-in loss that is disallowed retains its charactr as a capital loss or ordinary loss and is carried forward under the rules applicable to a loss of that character.

4. Testing preiod: Shorter period where all losses arise after three-year period begins (sec. 6666 of the bill, sec. 621 of the Reform Act, and sec. 382(i)(3) of the Code)

Present Law

The testing period for determining whether an ownership change has occurred generally is the three-year period proceding any owner shift involving a five-percent shareholder or any equity structure shift. After an ownership change, the testing period does not begin before the day following the first owership change. If the corporation does not have a net unrealized built-in loss, the testing period does not begin before the first day of the first taxable year from which there is a loss carryforward.

Explanation of Provision

The bill clarifies that the testing period does not begin before the earlier of (1) the first day of the first taxable year from which there is a loss carryforward, or (2) the first day of the taxable year in which the transaction being tested occurs. Thus, where there is a current net operating loss for the taxable year in which an ownership change occurs, the testing period is determined by taking such taxable year into account.

5. Definitions of loss corporation, old loss corporation, and new loss corporation (sec. 6666 of the bill, sec. 621(a) of the Reform Act, and secs. 382(k) and 382(1)(8) of the Code)

Present Law

The special limitations apply to the taxable income of any "new loss corporation." The term "loss corporation" is defined to include a corporation entitled to use a net operating loss carryover. A "new loss corporation" is a corporation that is a loss corporation after an ownership change. The same corporation may be both the old loss corporation and the new loss corporation.

An "old loss corporation" is a corporation with respect to which there is an ownership change, which was a loss corporation before the ownership change, or with respect to which there is a pre-change loss. A pre-change loss is any net operating loss carryforward of an old loss corporation to the taxable year ending with or in which the ownership change occurs, and the net operarting loss of an old loss corporation for the taxable year in which the ownership change occurs (to the extent allocable to the period on or before the change date).

In determining whether an ownership change has occurred, the percentage of stock in the new loss corporation is compared to the lowest percentage of stock in the old loss corporation (or any predecessor) owned by a shareholder during the testing period.

Explanation of Provision

The bill clarifies that the definition of a loss corporation includes a corporation entitled to use a pre-charge loss (that is, a net operating loss for the taxable year in which an ownership change occurs, as well as a net operating loss carryover to such year). Thus, for example, the definition of a new loss corporation includes a corporation that is entitled to use a net operating loss that was incurred in the taxable year in which an ownership change occurred.

Except as provided in regulations, any entity and any predecessor or successor of such entity is treated as one entity. As an example, if a corporation purchases 100 percent of the stock of an unrelated loss corporation, the loss corporation would become a new loss corporation. If the new loss corporation liquidates in a tax-free transaction pursuant to section 332 (so the new loss corporation's net operating loss carryforwards carry over to the acquiring corporation), the acquiring corporation—as successor—will continue to be treated as a new loss corporation.

The bill also modifies the definition of ownership change by eliminating the references to "old" and "new" loss corporations.

This change merely eliminates circularity in the definition of ownership change, and is not intended to have any substantive effect.

6. Operating rules relating to ownership of stock (sec. 6666 of the bill, sec. 621(a) of the Reform Act, and sec. 382(1)(3) of the Code)

Present Law

In determining whether an ownership change has occurred, changes in the holding of certain preferred stock are disregarded, and the constructive ownership rules of section 318 are applied with several modifications.

One modification to the rules of section 318 relates to options and similar interests. Except as provided in regulations, the holder of an option is treated as owning the underlying stock if such presumption would result in an ownership change. Thus, the stock underlying an option or similar interest may be taken into account on and after the date on which the interest is acquired or later transferred. The subsequent exercise of an option is disregarded if the holder of the option has been treated as owning the underlying stock. On the other hand, if the holder of an option was not treated as owning the underlying stock, the subsequent exercise will be taken into account in determining whether there is an owner shift at time of exercise. Similarly, except as provided in regulations, a person is treated as owning stock that may be acquired pursuant to any contingent purchase, warrant, convertible debt, put, stock subject to a risk of forfeiture, contract to acquire stock, or similar interest, if such a presumption results in an ownership change.[6]

The Act does not provide rules for attributing stock that is owned by a government. For example, stock that is owned by a foreign government is not treated as owned by any other person. Thus, if a government of a country owned 100 percent of the stock of a corporation and, within the testing period, sold all of such stock to members of the public who were citizens of the country, an ownership change would result. Governmental units, agencies, and instrumentalities that derive their powers, rights, and duties from the same sovereign authority will be treated as a single shareholder.

Explanation of Provision

The bill clarifies that the constructive ownership rules of section 318 are applied only to "stock" that is taken into account for purposes of section 382. For example, assume a corporation owns both common stock and stock of a type that is not counted in determining whether there has been an ownership change (referred to as "pure preferred") in a holding company. The pure preferred represents 55 percent of the holding company's value. The holding company's only asset consists of 100 percent of the common stock in an operating subsidiary that is a loss corporation. The sale of the pure preferred would not constitute an ownership change because no stock in the loss corporation may be attributed through pure preferred. On the other hand, assume 100 perent of the stock in a loss corporation is transferred in a section 351 exchange, in which the loss corporation's sole shareholder receives pure preferred representing 51 percent of the transferee's value, and an unrelated party receives 100 percent of the transferee's common stock. Here, an ownership change would result with respect to the loss corporation. Similar rules apply where a loss corporation is owned directly or indirectly by a partnership (or other intermediary) that has outstanding ownership interests substantially similar to a pure preferred stock interest.

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[6] Thus, the type of rights to acquire stock that are subject to the option rule may extend beyond those rights that have been treated as options under section 318(a)(4) as applied for other purposes. For example, a right to acquire unissued stock in a corporation would (except as provided by regulations) be treated as exercised if an ownership change would result, without regard to how such right may have been treated under section 318(a)(4). The Treasury Department will exercise its regulatory authority to prevent the use of the option rule in appropriate cases—as one example, where options or similar interests are issued shortly after a corporation has incurred a de minimis amount of loss.

The bill also clarifies that the rule with respect to options extends bayond options that have been subject to section 318(a)(4).

7. Bankruptcy proceedings (sec. 6666 of the bill, sec. 621(a) of the Reform Act, and sec. 382(l)(5) of the Code)

Present Law

The special limitations do not apply to an ownership change if the old loss corporation was under the jurisdiction of the court in a title 11 or similar case immediately before the ownership change, and the shareholders and creditors of the old loss corporation own 50 percent or more of the value and voting power of the new loss corporation. However, the net operating losses of the corporation are reduced by any interest deductions on debt converted to stock for interest that was paid or accrued during the prior three years. Also, net operating losses are computed as if 50 percent of the amount that, but for section 108(e)(10(B), would have been included in gross income, had been so included.

A new loss corporation may elect to forgo the special bankruptcy rule described above, in which case, the general rules will apply except the value used for purposes of computing the section 382 limitation will be the value of the new loss corporation immediately after the ownership change.

A modified version of the bankruptcy exception applies to a thrift involved in an equity structure shift that is a reorganization described in section 368(a)(3)(D)(ii), or any other equity structure shift or transaction to which section 351 applies that occurs as an integral part of a transaction involving a reorganization described in section 368(a)(3)(D)(ii). The bankruptcy exception is applied to qualified thrift reorganizations by requiring shareholders, creditors, and depositors to retain a 20-percent (rather than 50-percent) interest. For this purpose, the fair market value of the outstanding stock in the new loss corporation includes deposits that become deposits of the new loss corporation.

Explanation of Provision

The bill clarifies that, for purposes of the 50-percent test, stock of a shareholder is taken into account only to the extent such stock was received in exchange for stock or a qualified creditor's interest that was held immediately before the ownership change. Thus, for example, stock received by a former stockholder for new consideration, such as the provision of funds to the corporation, a guarantee of corporate obligations, or any other consideration, is not taken into account. Similarly, stock purchased from other stockholders in the transaction is not counted. The bill also clarifies that stock received by a qualified creditor is taken into account only to the extent such stock was received in satisfaction of qualified indebtedness.

The bill clarifies the attribute reduction that occurs with respect to amounts that would be cancellation of indebtedness income. The amount of the reduction is 50 percent of the amount that (but for section 108(e)(10)(B)) wouild have been applied to reduce tax attributes under section 108(b), that is, the excess of the amount of cancelled debt over the fair market value of stock issued in satisfaction of the debt. The bill also clarifies that the amount of the debt outstanding for this purpose does not include previously accrued but unpaid interest that has already been deducted from net operating loss carryforwards under the rule requiring reduction for interest deducted during the three-year period prior to the ownership change.

The bill also clarifies that if an election to forgo the bankruptcy rule is made, the value of the new loss corporation will reflect any increase in value resulting from the surrender or cancellation of creditors' claims in the transaction.

Regarding qualified thrift reorganizations, the bill clarifies that the fair market value of the outstanding stock of the new loss corporation includes the amount of deposits in such corporation immediately after the change. Also, it is clarified that the voting power requirement will not cause a failure of the 20-percent test solely because deposits do not carry adequate voting power.

8. Limitation on amount of recognized built-in loss treated as pre-change loss (sec. 6666 of the bill, sec. 621(a) of the Reform Act, and sec. 382(h) of the Code)

Present Law

If a loss corporation has a net unrealized built-in loss, any built-in loss recognized during any taxable year during the five-year period following the ownership change is limited in the same manner as a pre-change net operating loss carryforward. This limitation does not apply to the extent the loss does not exceed the net unrealized built-in loss of the corporation reduced by built-in losses recognized in prior post-change years. Net unrealized built-in loss is defined as the excess of the adjusted basis of the corporation's assets on the change date over their fair market value. The Secretary of the Treasury is authorized to treat amounts that accrue on or before the change date, but that are allowable as a deduction after such date, as recognized built-in losses.

Explanation of Provision

The bill clarifies that net unrealized built-in loss includes amounts treated as built-in losses pursuant to the Secretary's authority to treat amounts accruing before the change-date but recognized after such date as recognized built-in losses.

9. Effective dates (sec. 6666 of the bill and sec. 621(f) of the Reform Act)

Present Law

The provisions of the Act generally apply to ownership changes that occur on or after January 1, 1987. The Act states that its provisions apply to an ownership change following an owner shift involving a five-percent shareholder occurring after December 31, 1986, or following an equity structure shift occurring pursuant to a plan of reorganization adopted after December 31, 1986.

The earliest testing period under the Act begins on May 6, 1986. If an ownership change occurs after May 5, 1986, and before January 1, 1987, and the provisions of the Act do not apply, then the earliest testing period will not begin before the day following the date of such ownership change.

Under the general rules of section 382, if a public offering is performed by an underwriter on a "firm commitment" basis, the underwriter is treated as owning the stock for purposes of determining whether an owner shift involving a 5-percent shareholder has occurred.

The Act contains certain targeted transition provisions.

Explanation of Provisions

The bill clarifies that the provisions of the Act apply to ownership changes occurring after December 31, 1986. For purposes of this transition rule, and for purposes of determining when a new testing period starts under section 3282(i), any equity structure shift pursuant to a plan of reorganization adopted before January 1, 1987 is treated as occurring when such plan was adopted.[7]

By treating equity structure shifts pursuant to plans of reorganization that were adopted before January 1, 1987 as occurring when the plan was adopted, the bill clarifies that no equity structure shift pursuant to a plan adopted after 1986, and no other owner shift involving a 5-percent shareholder occurring after 1986, is protected under the transition provisions, even though such shifts may occur before the completion of a pre-1987 plan of reorganization; i.e., such shifts are not grandfathered by virtue of the pre-1987 plan. If, however, an ownership change occurs within the testing period prior to the end of 1986 when any equity structure shift pursuant to a pre-1987 plan is considered together with other pre-1987 owner shifts, that ownership change is grandfathered and a new testing period starts. Any equity structure shift pursuant to a plan adopted after 1986, and any post-1986 owner shift involving a 5-percent shareholder, that occurs before the completion of the pre-1987 plan of reorganization will count for purposes of determining when or whether a later ownership change occurs, under section 382(i).

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[7] The bill thus clarifies that the transition rule for equity structure shifts pursuant to pre-1987 plans of reorganization is applicable even though such equity structure shift may also be an owner shift involving a 5-percent shareholder.

If, applying the foregoing provisions and the rule in section 381(l)(2) (described below), an ownership change occurs immediately following an equity structure shift pursuant to a post-1986 plan of reorganization, or immediately following any other post-1986 owner shift involving a 5-percent shareholder the ownership change is subject to the provisions of section 382 as amended by the Act.

The bill clarifies that the May 6, 1986 testing date applies for purposes of determining whether an ownership change occurred after May 5, 1986 and before January 1, 1987. For purposes of determining whether shifts in owership occurred between May 5, 1986, and January 1, 1987, the rule in section 382(l)(3) for options and similar interests applies. Thus, in the case of such an interest issued on or after May 6, 1986, and before January 1, 1987, the underlying stock could be treated as acquired at the time the interest was issued. For this transition period, however, in addition to the Treasury Department's general regulatory authority under the rule in section 382(l)(3), the Treasury Department may provide for different treatment in the case of an acquisition of an option or similar interest that is not in fact exercised, as appropriate where the effect of treating the underlying stock as if it were acquired would be to cause an ownership change that would start a new testing period (and thus result in relief under the transitional rules). No inference is intended as to how pre-May 6, 1986 options or similar interests would be treated.

The 1954 Code version of section 382 has continuing application to any increase in percentage points to which the provisions of the Act do not apply by reason of any transitional rule—including the rules prescribing measurement of the testing period by reference only to transactions after May 5, 1986, and the rules that disregard ownership changes following or resulting from certain transactions.

Unless the corporation elects otherwise, an underwriter of an offering for a corporation before September 19, 1986, will not be treated as having acquired stock in the corporation by reason of a firm commitment underwriting, to the extent the stock is disposed of pursuant to the offering, but no later than 60 days after the initial offering.

Any regulations that have the effect of treating a group of shareholders as a separate five-percent shareholder by reason of a public offering will not apply to the institutions described in section 591, for any period before January 1, 1989. Further, an underwriter of any offering for such an institution will not be treated as acquiring stock in the institution by reason of a firm commitment underwriting, but only to the extent such stock is disposed of no later than 60 days after the initial offering and pursuant to the offering.

The bill makes certain corrections to specific targeted transition provisions.

E. Recognition of Gain or Loss on Liquidating Sales and Distributions of Property (*General Utilities*)

1. Limitations on recognition of loss (secs. 6666 of the bill, sec. 631(a) of the Reform Act, and secs. 336(d)(2) and 336(d)(3) of the Code)

Present Law

A corporation generally recognizes gain or loss on a sale or distribution of property, whether or not in liquidation. However, under the statute, loss is not recognized in certain circumstances (*see, e.g.*, sec. 336(d)).[1] One circumstance in which loss is not recognized involves the sale, exchange or distribution of property acquired by a liquidating corporation in a transaction to which section 351 applied or as a contribution to capital, if the acquisition of such property was part of a plan a principal purpose of which was to recognize loss by the liquidating corporation in connection with the liquidation. In these circumstances, the basis of the property for purposes of determining loss is reduced, but not below zero, by the excess of the adjusted basis of the property on the date of contribution over its fair market value on such date.[2] The statute provides that if the adoption of a plan of complete liquidation occurs in a taxable year following the date on which the tax return including the loss disallowed by this provision is filed, the Secretary may prescribe regulations under which the loss may be recaptured in the year of liquidation, rather than requiring an amended return to be filed with respect to the year the loss was taken. The Act provides that property acquired by the liquidating corporation during the two-year period ending on the date of the adoption of the plan of liquidation shall, except as provided in regulations, be treated as part of such a plan subject to these provisions.[3]

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[1] Congress did not intend to create any inference regarding the deductibility of losses in liquidating or nonliquidating distributions or sales under other statutory provisions of judicially created doctrines, or to preclude the application of such provisions or doctrines where appropriate. See, *e.g.*, sec. 482 and Treas. Reg. sec. 1.482-1(d)(5); *National Securities Corp. Comm'r*, 46 B.T.A. 562 (1942), cert. denied 320 U.S. 794 (1943) (loss on sale by subsidiary of securities transferred by parent, in nonrecognition transaction reallocated to parent, where purpose of transfer was to shift unrealized loss on securities to subsidiary); *Court Holding Co.* v. U.S., 324 U.S. 321 (1945) (corporation treated as true seller of property distributed to shareholders and purportedly sold by them to third party); and *Gregory* v. *Helvering*, 293 U.S. 465 (1935) (in addition to meeting literal requirements of statute, transaction must have valid business purpose to qualify for nonrecognition.)

[2] The effect of this rule of section 336(d)(2) is to deny recognition to the liquidating corporation of that portion of the loss on the property that accrued prior to the contribution, but to permit recognition of any loss accruing after the contribution. In the event that a transaction is described both in section 336(d)(1) (which denies loss accruing either before or after the contribution) and section 336(d)(2), section 336(d)(1) will prevail.

This provision was not intended to override section 311(a). Thus, if property is distributed in a nonliquidating context, the entire loss (and not merely the built-in loss) will be disallowed.

[3] Although Congess recognized that a contribution more than two years before the adoption of a plan of liquidation might have been made for such a tax-avoidance purpose, Congress also recognized that the determination that such purpose existed in such circumstances might be difficult for the Internal Revenue Service to establish and therefore as a practical matter might occur infrequently or in relatively unusual cases.

Congress intended that the Treasury Department will issue regulations generally providing that the presumed prohibited purpose for contributions of property within two years of the adoption of a plan of liquidation will be disregarded unless there is no clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises.

Continued

In the case of any liquidation to which section 332 of the Code applies, the Act provides that no loss shall be recognized in such liquidation.

Explanation of Provision

The bill clarifies that an acquisition of property by a corporation after the date two years before the date the corporation adopts a plan of complete liquidation (rather than merely during the two-year period ending on the date of the adoption of the plan) shall, except as provided in regulations, be treated as acquired as part of a plan a principal purpose of which was to recognize loss by the liquidating corporation in connection with the liquidation.

The bill also clarifies that the provision denying recognition of loss to the distributing corporation in a section 332 liquidation is intended to apply to a distribution to the corporation meeting the control requirement of section 332 only if the distribution does not result in gain recognition to the distributing corporation, pursuant to section 337(a) or (b)(1). Thus, the provision denies loss recognition on a taxable distribution to minority shareholders in such a liquidation. If the section 332 liquidation is not described in section 337(b)(1) or (2) (for example, in the case of certain liquidation into a tax exempt parent corporation) the special loss disallowance provision of section 336(d)(3) does not apply. Such a transaction would be subject to any other applicable loss disallowance provisions, however.

2. Election to treat certain stock sales and distributions as asset transfers (sec. 6666 of the bill, sec. 631(a) of the Reform Act, and sec. 336(e) of the Code)

Present Law

Under regulations prescribed by the Secretary, a corporation may elect to treat certain sales and distributions of subsidiary stock as asset transfers.

A clear and substantial relationship between the contributed property and the conduct of the corporation's business enterprises would generally include a requirement of a corporate business purpose for placing the property in the particular corporation to which it was contributed, rather than retaining the property outside the corporation. If the contributed property has a built-in loss at the time of contribution that is significant in amount as a proportion of the built-in corporate gain at that time, special scrutiny of the business purposes would be appropriate.

Congress expected that such regulations will permit the allowance of any resulting loss from the disposition of any of the assets of a trade or business (or a line of business) that are contributed to a corporation where prior law would have permitted the allowance of the loss and the clear and substantial relationship test is satisfied. In such circumstances, application of the loss disallowance rule is inappropriate assuming there is a meaningful (i.e., clear and substantial) relationship between the contribution and the utilization of the particular corporation form to conduct a business enterprise. If the contributed business is disposed of immediately after the contribution it is expected that it would be particularly difficult to show that the clear and substantial relationship test was satisfied. Congress also anticipated that the basic adjustment rules will generally not apply to a corporation's acquisition of property as part of its ordinary start-up or expansion of operations during its first two years of existence. However, if a corporation has substantial gain assets during its first two years of operation, a contribution of substantial built-in loss property followed by a sale or liquidation of the corporation would be expected to be closely scrutinized.

Explanation of Provision

The bill clarifies that Congress did not intend to require the election to be made unilaterally by the selling or distributing corporation. The bill thus provides that, under regulation prescribed by the Secretary, an election may be made to treat the certain sales and distributions of subsidiary stock as asset sales. Compare section 338(h)(10).

3. Treatment of distributing corporation where the 80-percent distributee is a tax-exempt organization (sec. 6666 of the bill, sec. 631(a) of the Reform Act, and sec. 337(b)(2) of the Code)

Present Law

Gain or loss is generally not recognized to the distributing corporation on a certain distributions to a corporate parent that is an 80-percent distributee.[4] However, if the 80-percent distributee is a tax-exempt organization, this rule does not apply unless the organization uses the property in an unrelated trade or business. Furthermore, if the organization does not so use the property but subsequently dispose of the property or otherwise ceases to use it in an unrelated business, such disposition or cessation is a taxable event.

Explanation of Provision

The bill clarifies that the provision with respect to use in an unrelated trade or business was intended to apply to use in an activity the income from which is subject to tax under section 511(a).[5]

4. Basis adjustment in taxable section 332 liquidation (sec. 6666 of the bill and sec. 334 of the Code)

Present Law

A liquidation corporation requires gain or loss on certain liquidating distributions to which the rule of section 332(a) applies [6]—for example, certain distributions to a tax-exempt or foreign corporation.

Explanation of Provision

The bill clarifies that if gain is recognized on a distribution of property in liquidation described in section 332(a) to a corporate distributee meeting the stock ownership requirements of section 332(b), a corresponding increase in the distributee's basis occurs.

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[4] *But see,* sec. 6524 of the Bill, under Explanation of Provisions.

[5] A distribution to a charitable trust would not qualify as a distribution to an 80-percent distributee (since only a corporation can qualify as an 80-percent distributee). Accordingly, the bill deletes the reference to section 511(b)(2) in section 337(b)(2).

[6] *See also,* sec. 6524 of the Bill under Explanation of Provisions

5. Use of installment method by shareholders in certain liquidations (sec. 6666 of the bill, sec. 631(a) of the Reform Act, and sec. 453(h)(1)(B) of the Code)

Present Law

The Act retained prior law in providing that if, in a liquidation to which section 331 applies, the shareholder receives, in exchange for such shareholder's stock, certain installment obligations acquired by the corporation in respect of certain sales or exchanges of property, the receipt of payments under such an obligation by the shareholder shall be treated as the receipt of payment for the stock.

Explanation of Provision

The bill clarifies that, as under the law prior to the enactment of the Act, in the case of inventory the corporate sale or exchange must have been not only to one person but to one person in one transaction.

6. Certain distributions of partnership or trust interests (sec. 6666 of the bill, sec. 631 of the Reform Act, and secs. 386 and 311 of the Code)

Present Law

Under the Act, a corporation generally recognizes gain or loss on a liquidating distribution of property as if the corporation had sold the property to the distributee. A corporation also generally recognizes gain or loss on liqidating sales of proprty. Gain but not loss is generally recognized on a nonliquidating distribution. Distributions of partnership interests are thus also treated as sales, invoking the provisions of section 751 of the Code. A separate provision (sec. 386) also provides for the treatment of certain sales and distributions of partnership interests by corporations.

Explanation of Provision

The bill generally repeals section 386 of the Code as deadwood in light of the Act's amendments to sections 311, 336 and 337 of the Code. However, the bill restates, in section 311, the provision contained in present law section 386(d), that the Secretary may by regulations provide that the amount of gain recognized on a nonliquidating distribution of a partnership interest shall be computed without regard to any loss attributable to property contributed to the partnership for the principal purpose of recognizing such loss on the distribution (i.e., thereby reducing the gain otherwise recognized on the distribution and effectively recognizing a loss not permitted in a nonliquidating distribution).[7]

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[7] This provision is not intended to limit the operation of any present-law step-transaction or other doctrines that would disregard such loss. Such doctrines would also apply if a corporation with property on which loss would be disallowed under other Code provisions (such as sections 336(d)(1) or (d)(2)) contributed such property to a partnership to reduce the gain on distribution of the partnership interest and thus indirectly recognize the loss.

7. Losses on transactions between related taxpayers (sec. 6666 of the bill, sec. 631 of the Reform Act, and sec. 267 of the Code)

Present Law

No loss is generally allowed with respect to the sale or exchange of property between related taxpayers (other than a loss in case of a distribution in corporate liquidation) (sec. 267(a)). The Act provided that certain losses at the corporate level may be denied in a liquidation under other Code provisions (sec. 336(d)).

Explanation of Provision

The bill clarifies that section 267(a) does not apply either to any loss of the distributee or to any loss of the distributing corporation in the case of a distribution in complete liquidation. Losses may be denied under other provisions of law or judicially created doctrine as under present law.

8. Distributions of property to corporate shareholders (sec. 6666 of the bill, sec. 631 of the Reform Act, and sec. 301 of the Code)

Present Law

Section 301 of the Code provides generally that, in the case of a corporate distribution of property to a corporate distributee, the amount distributed is the lesser of (1) the fair market value of the property or (2) the adjusted basis of the property in the hands of the distributee, increased in the amount of gain recognized to the distributing corporation on the distribution. The basis of the property in the hands of the distributee is the same as the amount distributed.

If gain is recognized to the distributing corporation on a nonliquidating distribution, the holding period of the property in the hands of the distributee begins on the date of the distribution.

The Act provided that, on a nonliquidating distribution of property to a shareholder (including to a corporate shareholder), gain (but not loss) is recognized to the distributing corporation as if the property had been sold to the distributee at fair market value. On a liquidating distribution, gain or loss is generally recognized (though loss is not recognized in certain instances). Provisions of the Code other than section 301 generally provide for the basis of property received in a liquidation (secs. 331 and 334).

Explanation of Provision

Certain portions of section 301 are repealed as deadwood. Thus, section 301 of the Code is amended to provide that the amount distributed and the basis of property in the hands of a corporate distributed is the fair market value of the property. The holding period of such distributed property in the hands of the distributee begins on the date of the distribution, as under present law, but section 301(e) is not necessary to reach this result and is repealed.[8]

9. Certain transfers to foreign corporations (sec. 6666 of the bill, sec. 631(d) of the Reform Act, and secs. 367(a) and 367(e)(2) of the Code)

Present Law

Gain is recognized to a liquidating corporation in the case of a liquidating distribution to an 80-percent distributee that is a foreign corporation, unless regulations provide otherwise. It is expected that such regulations may permit nonrecognition if the potential gain on the distributed property at the time of the distribution is not being removed from the U.S. taxing jurisdiction prior to recognition.

Explanation of Provision

The bill clarifies that transfer of property to a foreign corporation in a transaction that would otherwise qualify as a tax-free reorganization is treated in the same manner as a liquidating transfer of such property to an 80-percent foreign corporate distributee. Thus, in the case of a transfer of property described in section 361(a) or (b) (as amended by the bill) by a U.S. corporation to a foreign corporation, the provisions of section 367(a)(2) and (3) do not apply, and gain is recognized unless regulations provide otherwise. However, subject to such basis adjustments as shall be provided in regulations, this rule does not apply if the foreign corporate transferee is 80-percent controlled (within the meeting of section 368(c)) by a domestic corporation or by members of the same affiliated group of corporations within the meaning of section 1504. It is expected that regulations will provide this relief only if the U.S. corporate shareholder agrees to take a basis in the stock it receives in a foreign corporation that is a party to the reorganization equal to the lesser of (a) the U.S. corporation's basis in such stock received pursuant to section 358, or (b) its proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation. U.S. taxing jurisdiction over the built-in gain in such cases of U.S. corporate control is indirectly related through the provisions of the Code relating to controlled foreign corporations. The requirement that certain U.S. corporate shareholders own at least 80 percent of the CFC stock assures that the bulk of the built-in gain will remain subject to U.S. taxing jurisdiction and justifies not imposing a partial tax on the portion of the gain not attributable to U.S. corporate shareholders. (Such a partial tax could present administrative difficulties in adjusting the basis of property in the hands of the transferee foreign corporation.)

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[8] This change is made solely as deadwood and is not intended to alter the consequences of a distribution under the consolidated return regulations or any other provision of law or regulation.

10. Gain from certain sales or exchanges of stock in certain foreign corporations (sec. 6666 of the bill, sec. 631(d) of the Reform Act, and sec. 1248 of the Code)

Present Law

Gain from certain sales or exchanges of stock in certain foreign corporations is characterized as a dividend to the recipient under section 1248 of the Code. Section 1248(f) contains various provisions that under prior law caused income recognitions and dividend treatment where a U.S. corporation sold, exchanged, or distributed the stock of a foreign corporation and gain and earnings and profits would not have occurred. This recognition was necessary because prior law treated certian liquidating sales and distributions and certain nonliquidating distributions by corporations as nonrecognition events.

Section 1248(d)(2) also contains a provision that was intended to assure that a foreign corporation that sold property in a liquidation would not experience an increase in earnings and profits to the extent that gain would not be recognized under section 337(a) of the Code on such a sale. This provision was originally written with reference to prior law section 337(a), which was repealed by the Act.

Under the Act, a distributing corporation generally recognizes gain on a liquidating or nonliquidating distribution of property with a fair market value in excess of basis as if the property distributed had been sold to the distributee at fair market value, and earnings and profits of the distributing corporation are accordingly increased. There are certain exceptions in the case of distributions that would be tax-free to a recipient under the tax-free reorganization provisions of the Code under section 355 of the Code, and in the case of certain liquidating distributions to an 80-percent corporate distributee.

Explanation of Provisions

The bill amends section 1248(f) to conform to the changes under the act that generally cause gain to be recognized, and earnings and profits to be created, on a liquidating sale or distribution or on a nonliquidating distribution, and that treat liquidating and nonliquidating distributions as sales or exchanges for this purpose. Section 1248(f)(1) under the bill applies only to certain distributions that are still nonrecognition events to the distributing corporation and are not treated as a sale by such corporation to the distributee—that is, distributions that would be tax-free to the recipient under the reorganization provisions of section 361(c) of the Code (as amended by the bill) or under section 355 of the Code and certain liquidating distributions to an 80-percent distributee. As under present law, section 1248(f)(2) excepts those situations in which the recipient U.S. corporation satisfies the stock ownership requirements of section 1248(f)(2) and is treated as holding stock for the period the stock was held by the distributing corporation.

It is contemplated that the Treasury Department may exercise its regulatory authority under section 1248(f) to provide that, in cases where a distribution that would be tax-free but for section

1248(f)(1) occurs within a controlled group, and section 1248(f)(2) does not otherwise apply, the recipient corporation may be required to take a carryover basis in the stock received (rather than a substituted basis under section 358, for example, in the case of a section 355 or 361 distribution) and section 1248(f)(1) will not apply to such distribution.

The bill repeals sections 1248(f)(3) and 1248(f)(2) as deadwood.

The bill makes certain other related clerical and conforming amendments.

11. Tax imposed on certain built-in gains of S corporations (sec. 6666 of the bill, sec. 632 of the Reform Act, and sec. 1374 of the Code)

Present Law

A corporate level tax is imposed on gain that arose prior to the conversion of a C corporation to an S corporation ("built-in gain") that is recognized by the S corporation though sale, distribution, or other disposition within 10 years after the date on which the S election took effect. The total amount of gain that must be recognized by the corporation, however, is limited to the aggregate net build-in gain of the corporation at the time of conversion to S status.

The Act provided that the amount of recognized built-in gains taken into account for any taxable year shall not exceed the excess (if any) of 1) the net unrealized built-in gain, over 2) the recognized built-in gains for prior years beginning in the 10-year recognition period.

Under the Act, the corporation may take into account certain subchapter C tax attributes in computing the amount of tax on recognized built-in gains. Thus, for example, it may use unexpired net operating losses to offset the gain and may use business credit carryforwards to offset the tax.

Explanation of Provision

The bill clarifies that the built-in gain provision applies not only when a C corporation converts to S status but also in any case in which an S corporation acquires an asset and the basis of such asset in the hands of the S corporation is determined (in whole or in part) by reference to the basis of such asset (or any other property) in the hands of the C corporation. In such cases, each acquisition of assets from a C corporation is subject to a separate determination of the amount of net built-in gain, and is subject to the provision for a separate 10-year recognition period. The bill clarifies that the Treasury Department has authority to prescribe regulations providing for the appropriate treatment of successor corporations—for example, in situations in which an S corporation engages in a transaction that results in carryover basis of assets to a successor corporation pursuant to subchapter C of the Code.

The bill clarifies that the amount of recognized built in gains taken into account for any taxable year shall not exceed the excess, if any, of 1) the net unrealized built-in gains at the time of the conversion, over 2) the recognized built-in gains for prior years beginning in the recognition period to the extent such gains were subject to the built-in gains tax.

The bill clarifies that, for purposes of this built-in gains tax under section 1374, any item of income which is properly taken into account for any taxable year in the recognition period but which is attributable to periods before the first taxable year for which the corporation was an S corporation is treated as a recognized built-in gain for the taxable year in which it is properly taken into account. Thus, the term "disposition of any asset" includes not only sales or exchanges but other income recognition events that effectively dispose of or relinquish a taxpayer's right claim or receive income. For example, the term "disposition of any asset" for purposes of this provision also includes the collection of accounts receivable by a cash method taxpayer and the completion of a long-term contract performed by a taxpayer using the completed contract method of accounting.

The bill clarifies that capital loss carryforwards may also be used to offset recognized built-in gains.

The bill makes certain other clerical and conforming changes.

12. Distributions by S corporations (sec. 6666 of the bill and secs. 1363 (d) and (e) of the Code)

Present Law

Specific rules are provided for the distribution of appreciated property by S corporations, generally requiring the recognition of gain by the S corporation on distributions of appreciated property, with certain exceptions.

Explanation of Provision

The special rules provided in Code section 1363(d) and (3) of the Code are repealed as deadwood. Thus, for example, it is clarified that, pursuant to section 1371 of the Code, the provisions of subchapter C of the Code apply to determine the recognition of gain and loss in the case of a distribution by an S corporation.

13. Regulatory authority to prevent circumvention of provisions (sec. 6666 of the bill, sec. 631 of the Reform Act, and sec. 337(d) of the Code)

Present Law

The Act provided that the Treasury Department shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made to Subpart B of the Code under the Act, including regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations, including the consolidated return regulations and Part III of the Code, dealing with corporate organizations and tax-free reorganizations.

Explanation of Provision

The bill clarifies that the regulatory authority to prevent circumvention of the provisions of the Act extend to all the amendments made by subtitle D of Title VI of the Act. The bill also clarifies in connection with the built-in gain provisions of the Act that the Treasury Department shall prescribe such regulations as may be necessary or appropriate to carry out those provisions, including provisions dealing with the use of such pass-through entities, other than S corporations as regulated investment companies (RICs) or real estate investment trusts (REITs). For example, this includes rules to require the recognition of gain if appreciated property of a C corporation is transferred to a RIC or a REIT in a carryover basis transaction that would otherwise eliminate corporate level tax on the built-in appreciation.

It is expected that Treasury shall also prevent the avoidance of the section through contributions of property with built-in loss to a corporation before it becomes an S corporation.

It is also expected that the Treasury Department will prevent the manipulation of accounting methods or other provisions that may have the result of deferring gain recognition beyond the 10 year recognition period—for example, in the case of a C corporation with appreciated FIFO inventory the converts to S status and elects the LIFO method of accounting.

Section 704(c) of the Code generally requires that gain attributable to appreciated property contributed to a partnership by a partner be allocated to that partner; it is expected that this rule would generally prevent the use of a partnership to avoid the purposes of the amendments made by subtitle D of Title VI of the Act (for example, by attempting to shift the tax on C corporation appreciation to another party or to a non-C corporation regime). However, if and to the extent that partners might utilize allocation rules or other partnership provisions to shift the incidence of gain recognition or to defer the recognition of built-in gain to a corporate partner, it is intended that the Treasury Department may exercise its authority to prevent such results.

14. Transition provisions (sec. 6666 of the bill and sec. 633 of the Reform Act)

a. Built-in gains of S corporations (sec. 6666 of the bill and sec. 633(b) of the Reform Act)

Present Law

The provisions of the Act (new Code section 1374) that impose a corporate level tax on certain built-in gains of C corporation assets after conversion to S status do not apply unless the first taxable year for which the former C corporation is an S corporation is pursuant to an election made after December 31, 1986. Prior law section 1374 will apply if Code section 1374 as amended by the Act does not apply.

Explanation of Provision

The bill clarifies that, for purposes of the transition provisions, if a corporation was a C corporation at any time prior to December 31, 1986, any "S" status of such corporation prior to its "C" corporation status is disregarded. Thus, the bill provides that (subject to the special small corporation transition rules of the Act) the built-in gains provisions apply to taxable years beginning after December 31, 1986, in cases where the return for the taxable year is filed pursuant to an S election made after December 31, 1986.

The bill clarifies that a 34-percent tax rate applies to capital gain that is subject to prior law section 1374 in taxable years beginning after December 31, 1986.

b. General transition rule based on pre-August 1, 1986 action (sec. 6666 of the bill and sec. 633(c)(1)(B) of the Reform Act)

Present Law

The statute states that the amendments made by the Act do not apply to distributions or sales or exchanges by a corporation if 50 percent or more of the voting stock by value of such corporation is acquired on or after August 1, 1986, pursuant to a written binding contract in effect before such date and if such corporation is completely liquidated before January 1, 1988. The conference report states that this transition rule applies if "a majority" of the voting stock was acquired pursuant to such binding written contract.

In addition, the amendments made by the Act do not apply to any transaction described in section 338 with respect to any target corporation if a qualified stock purchase of such target corporation was made on or after August 1, 1986, pursuant to a written binding contract in effect before such date, and the acquisition date is before January 1, 1988.

Explanation of Provision

The bill clarifies that the transition rule applies if more than 50 percent (rather than 50 percent or more) of the voting stock is acquired pursuant to the binding written contract.

The committee wishes to make a clarification regarding the exception for a qualified stock purchase pursuant to a binding contract in effect before August 1, 1986. For purposes of this exception, a modification of a contract for the purchase of stock in more than one corporation that arises because of third party rights in the stock to be acquired (such as a right of first refusal), or because of the rules and rulings of government agencies or courts, is not intended to cause a contract to be deemed nonbinding, so long as the stock acquired was a part of the original contract. This clarification is not intended to create any inference regarding the meaning of binding contract in other contexts.

c. Transitional rules for certain small corporations (sec. 6666 the bill and sec. 633(d) of the Reform Act)

Present Law

Special delayed effective dates are provided under the Act for certain closely held corporations that are limited in size. Corporations eligible for this rule are generally entitled to prior-law treatment with respect to liquidating sales and distributions occurring before January 1, 1989, provided the liquidation is completed before that date. However, the special transitional rule requires the recognition of income on distributions of ordinary income property and short-term capital gain property. The statute states that recognition is also required with respect to any gain to the extent section 453B of the Code applies.

The Act provides that a corporation eligible for this rule may also become an S corporation for a taxable year beginning before January 1, 1989. In such a case, the corporation is not subject to the new rules of section 1374 relating to built-in gains except with respect to ordinary income and short-term capital gain property.[9] The Act repealed section 333 of the Code. However, the amendments made by the Act do not apply to the applicable percentage of each gain or loss which would otherwise be recognized by reason of the Act. The applicable percentage is 100 percent if the applicable value of the qualified corporation is less than $5 million, and phases down to 0 percent if the applicable value of the corporation exceeds $10 million.

For distributions prior to January 1, 1989, qualifying corporations continue to be eligible for relief under the rules relating to nonliquidating distributions in effect prior to the Act (prior law sec. 311(d)(2)). However, this relief does not apply to distributions of ordinary income property or short-term capital gain property.

The Act provides that a corporation is eligible for these special delayed effective dates if it was in existence on August 1, 1986, its value does not exceed $10 million, and more than 50 percent (by value) of the stock is held by 10 or fewer qualified persons. The conference report states that such 10 or fewer qualified persons must have held their stock for five years or longer.

The Act provides that a qualified person is an individual, an estate, or any trust described in clause (ii) or (iii) of section 1361(c)(2)(A) of the Code. Specified attribution rules are provided for purposes of determining ownership.

The Act provides that all members of the same controlled group (as defined in section 267(f)(1) of the Code) are treated as one corporation for purposes of the small corporation transitional rules.

The Act provides that the small corporation transition rules shall also apply in the case of a transaction described in section 338 of the Code where the section 338 acquisition date is before January 1, 1989.

Explanation of Provision

The bill clarifies that a qualified corporation eligible for the special delayed effective dates does not recognize gain on a distribution of installment obligations that are received in exchange for long-term capital gain property (including section 1231 property the disposition of which would produce long-term capital gain) where the distribution of such obligations would not have caused corporate level recognition under sections 337 and 453B(d)(2) as in effect prior to the Act. However, distributions of such installment obligations received in exchange for ordinary income property or short-term capital gain property do require the recognition of corporate level gain.

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[9] However, a corporation having a value in excess of $5 million (but not in excess of $10 million) is subject to a phase-out of this relief. Thus, in such circumstances new section 1374 applies to a portion of the long-term capital gain. Section 1374 as in effect before the Act will apply to any portion of the built-in long term capital gains not subject to new section 1374. In addition, to the extent a corporation is eligible for relief under the small corporation rule, a portion of any other long-term capital gain that would be covered by prior law section 1374 (whether or not built-in at the time of conversion) continues to be covered by that section.

It is intended that a taxpayer that purchases the stock of a qualified corporation in a qualified stock purchase prior to January 1, 1989, is entitled to apply prior-law rules (modified as in the case of actual liquidations) with respect to an election under section 338, even though in the hands of the acquiring corporation the qualified corporation no longer satisfies the stock holding period requirements and may not satisfy the size or shareholder requirements due to the size or shareholders of the acquiring corporation.

The bill clarifies that, although the Act repealed section 333 of the Code, in the case of a liquidating distribution to which section 333 of prior law would apply, a shareholder of a qualified corporation electing such treatment is entitled to apply section 333 without any phase-out of shareholder level relief under the Act. However, an increase in shareholder-level gain could result from an increase in corporate earnings and profits resulting from application of the corporate-level phase-out of relief.

The bill clarifies that for distributions before January 1, 1989, qualifying corporations continue to be eligible for relief under prior-law rules relating to nonliquidating distributions with respect to qualified stock, (prior law sec. 311(d)(2)), without regard to whether the corporation liquidates before January 1, 1989. However, this relief does not apply to distributions of ordinary income property or short-term capital gain property.

The bill clarifies that a corporation is not a qualified corporation unless more than 50 percent (by value) of the stock of such corporation is owned (on August 1, 1986 and at all times thereafter before the corporation is completely liquidated) by the same 10 or fewer qualified persons. Notwithstanding the conference report, no holding period requirement applies for this purpose.

Where stock passes to an estate, the holding period of the estate includes that of the decedent. Also, the "look-through" attribution rules that apply under this provision do not apply in the case of trusts qualifying under section 1361(c)(2) (ii) or (iii), just as they do not apply under the Act in the case of estates. Thus, stock held by such entities, like stock held by an estate, is to be treated as held by a single qualified person, so that the 10-shareholder test will not cease to be satisfied merely because a decedent's stock passes to such a trust. (In the case of other trusts holding stock, the "look-through" attribution rules apply to determine whether more than 10 qualified persons ultimately own the stock).

The bill also clarifies that the holding period of a decedent's estate (or a section 1361(c)(2)(A) (ii) or (iii) trust) is tacked with that of any beneficiary, as well as with that of the decedent, for purposes of determining the holding period. However, except in the case of beneficiaries who are treated as being "one person" with the decedent, once stock has been distributed to beneficiaries, the 10-shareholder requirement might fail to be satified due to an increase in the number of shareholders. Property acquired by reason of the death of an individual is treated as owned at all times during which the property was treated as owned (in addition to actually owned) by the decedent (as one example, property treated as owned by the decedent under the grantor trust rules, as well as property treated as owned by the decedent pursuant to attribution rules, would have a tacked holding period for this purpose).

In the case of indirect ownership through an entity, the rules described above are the only rules that apply to determine ownership and holding period. Thus, it is not intended that holding periods could otherwise be "bootstrapped" through analogy to or application of any provision of section 1223. For example, if a partnership owns all the stock of a corporation, a new partner who contributes other property to the partnership in exchange for a partnership interest is deemed under section 1223 to have a holding period in the partnership interest that includes such person's holding period for the property contributed. However, such a person would not be deemed thereby to have owned stock in the corporation that the partnership owned for any period prior to the time the person became a partner. In such cases, under the attribution and other holding period rules of the transitional provision a qualified person's holding period for the underlying stock is the lesser of (1) the period during which the entity held the stock in the qualified corporation, or (2) the period during which the qualified person held the interest in the entity. In other situations, the basic attribution and holding period rules of the transitional rule provision may provide a different result.[10]

The bill clarifies that the rule that all members of a controlled group of corporations (as defined in section 267(f)(1)) are treated as a single corporation applies solely for purposes of determining whether the corporation meets the size requirements for relief. Thus, it is clarified that it is not necessary for all members of a group that, in the aggregate, meets the size requirements for a qualified corporation, to liquidate before January 1, 1989, in order for the liquidation of one member of the group to qualify for relief. It is not intended that an S corporation be included as a member of the group unless such corporation was a C corporation for its taxable year including August 1, 1986 or was an S corporation that was not described in section 1374(c) (1) or (2) of prior law for such taxable year.

The bill also provides a rule to prevent the use of qualified corporations as conduits for the sale of assets by corporations that are not qualified. It is expressly provided that the transition rules do not apply where a principal purpose of a carryover basis transfer of an asset to a qualified corporation is to secure the benefits of the special transition rules. This provision is not intended to limit the application of the step transaction doctrine or other doctrines that would prevent the use of the transition rules. It is expected that a similar step transaction approach would be applied in the case of any transfer of assets to any corporation that qualified for transition under any of the other provisions of the Act, if a principal purpose of the transfer was to secure the benefit of transition for an otherwise non-qualified transaction.

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[10] For example, if a qualified person held stock of a corporation and subsequently contributed that stock to a partnership, the person's holding period would include the entire period the stock was held, directly or indirectly.

The bill does not make any statutory change with respect to section 1223 since section 1223 does not by its terms operate to extend attribution periods, as explained above.

The bill makes certain other clerical and conforming changes.

d. Other transitional rules (sec. 6666 of the bill and secs. 633(f) (2), (3), (4), and (5) of the Reform Act)

Present Law

The Act provided certain targeted transitional rules.

Explanation of Provision

The bill makes certain corrections to the existing targeted transitional rules.

F. Allocation of Purchase Price in Certain Sales of Assets (sec. 6666 of the bill, sec. 641 of the Reform Act, and sec. 1060 of the Code)

Present Law

Under the Act, in the case of an "applicable asset acquisition" both the buyer and the seller must allocate purchase price using the so-called "residual method" of allocation. Thus, both parties must use this method, as described in regulations under section 338 of the Code.[11] An applicable asset acquisition is any transfer of assets constituting a business in which the transferee's basis is determined wholly by reference to the purchase price paid for the assets.[12]

The Treasury Department is authorized to require information reporting by the parties to an applicable asset acquisition.

Explanation of Provisions

The bill provides that section 1060 applies to a distribution or transfer of an interest in partnership to which section 755 applies, for purposes of determining the value of goodwill or going concern value (or similar items) under section 755.[13]

The bill provides that any information reporting required by the Treasury Department pursuant to this provision constitutes an information return for purposes of the penalty provisions of the Code.

The bill makes certain other clerical and conforming changes.

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[11] See. Temp. Treas. Reg. sec. 1.338(b)-2T. The Act endorsed the use of the residual method generally and applied the same method regardless of whether a transfer took the form of a stock transfer or an asset transfer. The Act did not preclude the Treasury Department from making changes to the final regulations, not inconsistent with the statutory purpose.

[12] A transaction may constitute an applicable asset acquisition even though section 1031 (relating to like-kind exchanges) applies to a portion of the assets transferred.

[13] The provisions of section 1060 of the Code are not intended to preclude the Internal Revenue Service from applying the residual method in other situations, including situations not involving an applicable asset acquisition, pursuant to its authority under other provisions of the Code.

G. Related Party Sales (sec. 6666 of the bill, sec. 642 of the Reform Act, and sec. 453 of the Code)

Present Law

Installment sale treatment is not available for gain on a sale of property to a related party; rather, the seller must include all payments to be received in the year of the disposition. Contingent payments must also be included in the seller's income in the year of disposition. Under the Act, in the rare and extraordinary case in which the fair market value of contingent payments may not be reasonably ascertained, basis shall be recovered ratably. The so-called "open transaction" cost-recovery method of reporting sanctioned in *Burnet* v. *Logan,* 283 U.S. 404 (1931) may not be contingent payments, the purchaser may not increase basis by any amount until the seller has included such amount in income.[14]

Related parties include a person and all entities more than 50 percent owned, directly or indirectly, by that person. Related parties also generally include entities more than 50 percent owned, directly or indirectly, by the same persons.

Explanation of Provisions

The bill clarifies that the requirement that the purchaser may not increase basis by any amount until the seller has included such amount in income applies not only to contingent payments as to which the fair market value may not be reasonably ascertained but also to any other amount in an installment sale of depreciable property between related parties.

The bill also provides that related parties, for purposes of these installment sale provisions, include partnerships that are more than 50 percent owned, directly or indirectly, by the same persons.

H. Amortizable Bond Premium (Sec. 6666 of the Bill, Sec. 643 of the Reform Act, and Sec. 171 of the Code)

Present Law

The deduction for amortizable bond premium is treated as interest, except as otherwise provided in regulations. Thus, for example, bond premium is treated as interest for purposes of applying the investment interest limitations.

The provision is effective for obligations acquired after October 22, 1986. For taxpayers who haved elections in effect as of October 22, 1986, the statute provides that such elections will apply to obligations issued after that date only if the taxpayer so chooses (in such manner as may be prescribed by the Secretary).

Explanation of Provision

The bill provides that, except as otherwise provided in regulations, amortizable bond premium is treated as an offset to interest income on the bond, rather than as a separate interest deduction item subject to the various provisions relating to interest deductions.

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[14] No inference was intended as to the viability of the cost recovery method under prior law.

The bill provides that, for taxpayers who have elections in effect as of October 22, 1986, such elections will apply to obligations acquired after that date (rather than to obligations issued after that date) only if the taxpayer so chooses (in such manner as may be prescribed by the Secretary).

I. Certain Entity Not Taxed as a Corporation (Sec. 646 of the Reform Act and Sec. 6666 of the bill)

Present law

The Act provided that a certain trust (Great Northern Iron Ore Trust) is not taxed as a corporation if specified conditions are satisfied, including non-exercise of certain powers contained in its trust instrument.

Explanation of Provision

The bill makes certain clarifications and corrections regarding the conditions that must be satisfied in order that the trust not be taxed as a corporation.

J. Regulated Investment Companies (Secs. 6666 of the bill, Secs. 651–657 of the Reform Act, and Secs. 851, 852 and 4982 of the Code)

Present law

Excise tax on undistributed income

Section 4982 imposes an excise tax on the undistributed income of regulated investment companies. In order to avoid paying this tax, a RIC must, during the calendar year, distribute 97 percent of its ordinary income for the calendar year and 90 percent of its capital gain net income for the one-year period ending on October 31 of such calendar year. The amount of capital gain net income is not reduced by the amount of any net operating loss of the RIC.

A RIC is given sufficient earnings and profits so that any distribution that otherwise is treated as dividend by the RIC qualifies as a dividend under the excise tax. No additional earnings and profits are created for redemption distributions that otherwise may qualify for a dividends paid deduction

Definition of Regulated Investment Company

A RIC must derive at least 90 percent of its income from certain specified sources, including income that is derived with respect to its business of investing in stocks, securities or currencies (the "90 percent test"). In addition, a RIC must derive less than 30 percent of its gross income from the sale or other disposition of stock or securities held for less than 3 months (the "30 percent test"). In the case of RICs that have so-called series funds, the above tests are applied to each fund separately.

A corporation that is registered as a business development company under the Investment Company Act of 1940, is eligible to be a RIC.

Explanation of Provisions

Excise tax on undistributed net income

The bill provides that in determining a RIC's ordinary income under the excise tax, gain or loss attributable to a section 988 transaction which would be properly taken into account for the portion of the calendar year after October 31 is taken into account in the following year. This provision does not apply to a RIC electing to use its taxable year for purposes of computing the excise tax.

Under the bill, for purposes of determining the amount that a RIC must distribute in order to avoid the excise tax under section 4982, a RIC may reduce (but not below its net capital gain) its capital gain net income (as computed for purposes of section 4981) by the amount of any "net ordinary loss" of the RIC. The net ordinary loss of the RIC is equal to the amount that would be the net operating loss of the RIC for the calendar year, with certain modifications. The net capital gain of the RIC for this purpose has the same meaning as under section 1221(11) determined by treating the one-year period ending on October 31 of the calendar year (or such other one year period used by the RIC for purposes of section 4982) as the company's taxable year.

Under the bill, in the case of a RIC that does not have a taxable year ending on October 31, and has not elected to use its own taxable year for purposes of computing the excise tax under section 4982, the earnings and profits of the RIC are determined without regard to any net capital loss or net foreign currency loss attributable to transactions after October 31 of such year, but only to the extent that the amount distributed during the calendar year does not exceed the required distribution for such calendar year (as determined under section 4982).

The bill creates an exception to the excise tax where the RIC is owned mostly by specified tax-exempt entities. The tax does not apply to any RIC for any calendar year if at all times during such year, all its shareholders were certain segregated asset accounts of insurance companies or qualified trusts. Shares attributable to an investment of less than $250,000 made in connection with the organization of a RIC will not prevent the RIC from qualifying for this exception.

Definition of regulated investment company

The bill clarifies that income derived by a RIC from a partnership or trust shall be treated as derived with respect to the RIC's business of investing in stocks, securities or currencies, only to the extent that such income is attributable to items of income which would be derived with respect to that business if realized by the RIC in the same manner as by the partnership or trust.[1]

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[1] This is similar to the rule used to characterize items of income, gain, loss, deduction or credit includible in a partner's distributive share. See I.R.C. section 702(b).

The bill also clarifies that the 30-percent test is applied with respect to sales or other dispositions of the stocks or securities (as defined for purposes of the 90-percent test), and options, futures, or forward contracts ("851(b)(3) property"). In the case of foreign currency gains (as defined in section 988(b)) directly related to the company's principal business of investing in stocks or securities, it is intended that such gains shall be treated as gains on 851(b)(3) property held for less than three months only to the extent derived as part of the gains on disposition of 851(b)(3) property held for less than three months. All foreign currency gains not directly related to the company's principal business of investing in stocks or securities shall be treated as gains on 851(b)(3) property held for less than three months. Thus, for example, foreign currency gains of a market maker in currencies generally shall be treated as gains on 851(b)(3) property held for less than three months without regard to any actual holding period.

In addition, the bill modifies the application of the 30-percent rule in two situations. First, the bill provides that gains after the adoption of a plan of complete liquidation are not to be taken into account under the test if the RIC liquidates within one taxable year.

Second, under the bill, a fund that belongs to a series will not be disqualified under the 30-percent test by reason of sales resulting from, and occurring within five days of, abnormal redemptions if (1) during that year the fund had abnormal redemptions aggregating more than thirty percent of net asset value and (2) all funds in the series would meet the test if treated as a single RIC. Abnormal redemptions occur if net redemptions on any day exceed one percent of the fund's net asset value.

The bill provides that a corporation that elects to be treated as a business development company under the Investment Company Act of 1940 is eligible to be a RIC.

K. Real Estate Investment Trusts (Sec. 6666 of the Bill, secs. 661–669 of the Reform Act, and Secs. 856–857 and 4981 of the Code)

Present Law

At least 75 percent of the gross income of a real estate investment trust (a "REIT") must be derived from certain specified sources including rents from real property and "qualified temporary investment income." Qualified temporary investment income is income attributable to the temporary investment of new capital (as defined in section 856(c)(6)(E)(ii)). In addition, with certain exceptions, less than 30 percent of the gross income of a REIT must be derived from the sale or exchange of certain properties, including real property held for less than four years, (the "30-percent test").

A REIT generally may not treat amounts as rents from real property in the determination of such amounts depends in whole or in part on the income or profits of any person from such property. An exception is provided where a REIT receives or accrues amounts with respect to real or personal property from a tenant that derives substantially all of its income with respect to such property from the subleasing of substantially all of such property, and such tenant receives or accrues only amounts that would be treated as rents from real property if received by the REIT. A similar rule is provided for interest.

Section 4981 imposes on REITs an excise tax on the excess of the required distributions over the distributed amount for the calendar year. The required amount equals the sum of specified percentages of its ordinary income and its capital gain net income. The amount of capital gain net income under the excise tax is not reduced by the amount of any net operating loss of the REIT. The distributed amount is increased by the amount of the dividends paid deduction. Net income from foreclosure property is not a required distribution, but amounts attributable to such income are included in the distributed amount, because they give rise to a dividends paid deduction.

Income from a shared appreciation provision relating to a loan held by the REIT that is secured by real property is treated as gain from the sale of the real property that secures the loan, effective for taxable years beginning after December 31, 1986.

Explanation of Provisions

The bill clarifies that for purposes of the definition of qualified temporary investment income, the term "debt instrument" has the same meaning as used for purposes of section 1275(a)(1). The bill provides that in the year in which a REIT is completely liquidated, for purposes of the 30 percent test, the REIT does not take into account any gain from the sale, exchange, or distribution of any property after the adoption of the plan of complete liquidation. The bill also provides that the provisions of the 1986 Act relating to the treatment of shared appreciation mortgages apply to taxable years beginning after December 31, 1986, but only with respect to obligations acquired after October 22, 1986.

The bill also clarifies that if a REIT receives or accrues amounts with respect to real or personal property from a tenant that derives substantially all of its income with respect to such property from the subleasing of substantially all of such property, and a portion of the amount that the tenant receives or accrues with respect to such property would be treated as rents from real property if received by the REIT, then the amounts received or accrued by the REIT from the tenant would not fail to be treated as rents from real property by reason of being based on the net income of profits of the tenant, to the extent that the amounts received or accrued by the REIT are attributable to amounts received by the tenant that would be treated as rents from real property if received by the REIT. A similar rule is provided for interest. In determining the portion of the rent (or interest) received from the tenant that may qualify as rent from real property (or interest) in these circumstances, allocation rules similar to those applicable under section 856(d)(4) (or section 856(f)(2)) are intended to apply.

Under the bill, for purposes of determining the amount that a REIT must distribute in order to avoid the excise tax under section 4981, a REIT may reduce its capital gain net income by the amount of any "net ordinary loss' of the REIT. The net ordinary loss of the

REIT is an amount equal to the amount that would be the net operating loss of the REIT for the calendar year, with certain modifications. In addition, so as to assure a consistent treatment of net income from foreclosure property, dividends attributable to such property are excluded from the definition of distributed amount.

L. Real Estate Mortgage Investment Conduits (Sec. 6666 of the Bill, Secs. 671-675 of the Reform Act, and Secs. 860A-860G and 865 of the Code)

Present Law

Requirements for qualification as a REMIC

To qualify as a real estate mortgage investment conduit ("REMIC"), substantially all of an entity's assets must consist of qualified mortgages and permitted investments as of the close of the fourth month ending after the startup day and each quarter thereafter (the "asset test").

A qualified mortgage is an obligation principally secured directly or indirectly by an interest in real property. It is unclear whether loans secured by stock in a cooperative housing corporation and debt instruments that are secured by other debt instruments, which other debt instruments are secured principally by interests in real property, may be treated as qualified mortgages. In general, a qualified mortgage must be transferred to a REMIC on or before the startup day, or purchased by the REMIC within three months of the startup day.

Permitted investments consist of cash flow investments, qualified reserve assets, and foreclosure property. A qualified reserve asset is intangible property which is held for investment and is part of a qualified reserve fund. A qualified reserve fund is any reasonably required reserve to provide for full payment of expenses of the REMIC or amounts due on regular interests in the event of defaults on qualified mortgages.

Foreclsoure property is property that would be foreclosure property if acquired by a real estate investment trust one-year period. Property ceases to be foreclosure property on the date which is one year after the date the REMIC acquired such property. No tax is imposed on the REMIC with respect to income from foreclosure property.

All interests in the REMIC must be regular interests or residual interests. A regular interest is an interest the terms of which are fixed on the startup day and which unconditionally entitled the holder to receive a specified principal amount and provide that interest amounts are payable based on a fixed rate. A residual interest is any interest that is so designated and that is not a regular interest in a REMIC. The startup day is any day selected by the REMIC that is on or before the first day on which regular interests in the REMIC are issued.

If an entity ceases to be a REMIC at any time during a taxable year, the entity may not be treated as a REMIC for such taxable year or any succeeding taxable year.

Taxes on the REMIC

A REMIC is required to pay a tax equal to 100 percent of the its net income from prohibited transactions. With certain exceptions, a deposition of a qualified mortgage is a prohibited transaction. No exception is provided for the repurchase of a defective mortgage in lieu of its substitution. In addition, any deposition of a cash flow asset is treated as a prohibited transaction.

Taxation of the holders of residual interests

Generally, the holder of a residual interest in a REMIC takes into account his daily portion of the taxable income or net loss of such REMIC for each day during which he held such interest. With certain exceptions, the taxable income of a REMIC is determined in the same manner as in the case of an individual.

The taxable income of any holder of a residual interest in a REMIC for any taxable year shall not be less than the excess inclusion for that year. Thrift institutions are excepted from this requirement and may therefore offset excess inclusion with net operating losses. The effect of these rules on affiliated groups is unclear.

If a tax-exempt organization subject to the tax on unrelated business income holds a residual interest, its excess inclusion is treated as unrelated business taxable income. The tax consequences of the holding of a residual interest by a tax-exempt organization which is not subject to the tax on unrelated business taxable income are uncertain.

Other provisions

For procedural purposes, a REMIC is treated as a partnership, and holders of a residual interest are treated as partners. Thus, a return for the REMIC must be signed by a holder of a residual interest.

Explanation of Provisions

Requirements for qualification as a REMIC

The bill makes the asset test continuous after the third month. Thus, after the third month, substantially all of a REMIC's assets must, at all times, consist only of qualified mortgages and permitted assets.

The bill clarifies the definition of a qualified mortgage by requiring that the mortgage be principally secured directly by an interest in real property. Thus, under the bill, debt instruments that are secured by other debt instruments, which other debt instruments are secured principally by interests in real property, may not be treated as qualified mortgages.[2] The bill provides, however, that loans secured principally by stock in a cooperative housing corporation may be treated as qualified mortgages. The bill also provides that to be treated as a qualified mortgage, an obligation must be transferred to a REMIC on the startup day in exchange for regular or residual interests in the REMIC or purchased by the REMIC within three months of the startup day pursuant to a fixed-price contract in effect on the startup day.[3]

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[2] A regular interest in a REMIC, which is treated as a debt instrument for Federal income tax purposes, may be treated as a qualified mortgage, however.

Under the bill, the definition of a qualified reserve fund is broadened to include reasonably required reserves to provide for full payment of amounts due on regular interests in the event of lower than expected returns on cash flow investments.

Under the bill, the definition of regular interest is broadened to encompass interests which entitle the holder to interest payments consisting of a specified portion of the interest payments on qualified mortgages if such payment does not vary during the period the regular interest is outstanding. Thus, to qualify as a regular interest under this language, an interest must have payments commencing from the startup day. The Committee's intent in broadening the definition is to permit an interest in a REMIC to qualify as a regular interest if the amount of interest is disproportionate to the specified principal amount.

The bill also provides that a regular interest in a REMIC must be issued on the startup day with fixed terms and must be designated as a regular interest. Under the bill, a residual interest also must be issued on the startup day. Under the bill, the startup day is any day in which the REMIC issues all of its regular and residual interests. In addition, to the extent provided in regulations, all interests issued and all transfers to the REMIC during any period (not exceeding 10 days) permitted in such regulations may be treated as occurring on the startup day.

Under the bill, if an entity ceases to be a REMIC during a taxable year by reason of a qualified liquidation, the entity may be treated as a REMIC for the taxable year in which the qualified liquidation occurs.

Taxes on the REMIC

The bill provides that the repurchase of a defective mortgage in lieu of substitution is not treated as a prohibited transaction. It also provides that the sale of cash flow investments required to prevent defaults on a regular interest where the threatened defaults result from a default on one or more qualified mortgages or to facilitate a clean-up call is not treated as a prohibited transaction.

In addition, if any property is contributed to the REMIC after the startup day, the bill imposes a tax on the REMIC for the taxable year in which the contribution is received equal to 100 percent of the amount (by value) of such contribution. Exceptions to this tax are made for cash contributions (1) made to facilitate a clean-up call or a qualified liquidation, (2) in the nature of a guarantee, (3) during the three months following the startup day, (4) to a qualified reserve fund by the holder of a residual interest or (5) as permitted in Treasury regulations. The bill also clarifies that a permitted cash-flow investment includes amounts held for a clean-up call.

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[3] For this purpose, mortgages may be considered to be purchased pursuant to a fixed-price contract despite the fact that the purchase price may be adjusted where the mortgages are not delivered by the seller on the startup day, provided that the adjustment is in the nature of damages for failure to deliver the mortgages rather than as a result of fluctuations in market price between the startup day and the date of delivery.

A clean-up call is the prepayment of the remaining principal balance of a class of regular interests when, by reason of prior payments with respect to those interests, the administrative costs associated with servicing that class outweigh the benefits of maintaining the class. It typically occurs when there is no more than a small percentage of the particular class of interests outstanding. It does not include the retirement of a class undertaken in order to profit from a change in interest rates.

Under the bill, if a tax-exempt organization holds a residual interest in a REMIC, the REMIC will be subject to a quarterly tax at the highest corporate rate on the excess inclusion of such organization to the extent that such excess inclusion is not subject to income tax, including the tax on unrelated business income. Such tax will be imposed regardless of whether the tax-exempt organization holds the interest directly or through pass-through entities.

Under the bill, a REMIC is subject to tax at the highest rate applicable to corporations on its "net income from foreclosure property." Net income from foreclosure property is the amount that would be the REMIC's net income from foreclosure property under section 857(b)(4)(B) if the REMIC were a real estate investment trust. Thus, if a REMIC acquires foreclosure property and receives amounts with respect to such property that would not be treated as certain types of qualifying income if received by a real estate investment trust (sec. 857(b)(4)(B)), then the REMIC would be subject to tax on such amounts. In addition, such property generally would be treated as foreclosure property for a period of two years, although this period may be shortened or extended under certain circumstances (sec. 856(e)). The amount of the REMIC's taxable income is reduced by any tax paid with respect to income from foreclosure property.

Taxation of holders of residual interests

Under the bill, the Treasury is granted regulatory authority to determine the taxable income of a REMIC in a manner other than as in the case of an individual. The committee intends that this authority be used to permit the REMIC generally to treat bad debts as other than nonbusiness bad debts, but not to take the dividends received deduction. It also intends that the Treasury use its authority to prevent individuals from using the REMIC election to circumvent their limitations on bad debt and capital loss deductions.[4]

The bill clarifies that all members of an affiliated group are treated as one taxpayer for purposes of the rule requiring that taxable income be no less than excess inclusions. Thus, net operating losses of the group cannot be used to offset excess inclusions. Also, the bill clarifies that the exception for thrift institutions is available only if the thrift itself, and not any affiliate of the thrift, holds the residual interest. Thus, net operating losses of the thrift may offset excess inclusions only in the case of residual interests held by the thrift.

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[4] The committee also intends that the income from residual interests will be treated as portfolio income for purposes of the passive loss rules.

Other provisions

For REMICs which are trusts or corporations under local law, the trustee or corporation, as the case may be, will have the same responsibility to file a return and pay tax as a residual holder. The committee expects that the Internal Revenue Service will issue Employer Identification Numbers to REMICs.

The bill also grants authority to the Treasury Department to provide appropriate rules for the treatment of transfers of qualified replacement mortgages to a REMIC where the transferor holds any interest in the REMIC. It is intended that these regulations may provide rules for determining the basis of mortgages transferred to or received from a REMIC as part of a replacement of qualified mortgages, and also may provide rules for determining or adjusting the basis of qualified mortgages held by the REMIC before or after the replacement. In addition, the bill grants authority to the Treasury Department to provide that a mortgage will be treated as a qualified replacement mortgage only if it is part of a bona fide replacement and is not part of a swap of mortgages. Thus, the Treasury is authorized to issue regulations which prevent a taxpayer from avoiding recognition on the exchange of appreciated mortgages by contributing such markup to a REMIC, and then having the REMIC (which will have a fair market value basis), exchange the mortgages for other mortgages.

The bill clarifies that certain provisions relating to REMICs are effective as of January 1, 1987. Thus, for example, interests in a REMIC are eligible to be treated as qualifying assets for a thrift institution, regardless of the institution's taxable year. In addition, the bill makes certain clerical and technical amendments to the statute.

Effective Date

In general, the provisions of the bill are effective as of January 1, 1987. The provisions relating to the definition of the startup day, the definitions of regular and residual interests, the requirement that qualified mortgages be transferred to the REMIC in exchange for regular or residual interests on the startup day or purchased pursuant to a fixed price contract, and the 100-percent tax on contributions of property to REMICs after the startup day do not apply to any REMIC whose startup day (as defined under present law) is before July 1, 1987. The provision relating to the asset test is effective as of January 1, 1988. The tax imposed where a tax-exempt organization owns a residual interest is effective as of October 16, 1987. The provision relating to the filing of returns is effective on the date of enactment.

VII. Minimum Tax Provisions (Sec. 6667 of the bill, Sec. 501 of the Reform Act, and Secs. 55-59 of the Code)

Present Law

Under present law, as amended by the Act, taxpayers are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent it exceeds the taxpayer's regular tax. The tax is imposed at a rate of 21 percent (20 percent in the case of a corporation) on alternative minimum taxable income in excess of an exemption amount. Alternative minimum taxable income generally is the taxpayer's taxable income, as increased or decreased by certain adjustments and preferences. The foreign tax credit generally is allowed to offset up to 90 percent of the tax, and the regular investment tax credit is allowed to offset up to 25 percent of a corporation's minimum tax.

Adjustments and preferences are provided for accelerated depreciation, mining exploration and development costs, certain long-term contracts, pollution control facilities, installment sales, circulation and research and experimental expenditures of individuals, miscellaneous itemized deductions, itemized deductions for State and local taxes, Merchant Marine Capital Construction Funds, special insurance deductions, percentage depletion in excess of basis, excess intangible drilling costs, incentive stock options, excess bad debt reserves of financial institutions, tax-exempt interest on certain bonds, appreciated property charitable deductions, farm losses, and passive losses.

In addition, for 1987 through 1989, one-half of the excess of pretax book income of a corporation over other alternative minimum taxable income is a preference. For taxable years beginning after 1989, three-fourths of the excess of adjusted current earnings over other alternative minimum taxable income is a preference.

These provisions are effective for taxable years beginning after December 31, 1986.

Explanation of Provisions

Computation of tax.—The bill provides that a taxpayer's regular tax will be reduced by the possessions tax credit under section 27(b) since income eligible for the credit is not included in the minimum tax base. The bill also clarifies that where a corporation's tax base is measured by something other than taxable income, such as unrelated business taxable income, real estate investment trust taxable income, or life insurance company taxable income, alternative minimum taxable income is determined using that tax base.

Adjustments.—The bill clarifies that the percentage of contract completed used for purposes of determining the minimum tax adjustment for long-term contracts is the same percentage as used for regular tax purposes under section 460, except that in the case of small construction contracts described in section 460(e)(1), the percentage of the contract completed shall be determined by using costs as determined for purposes of the regular tax and by using the simplified procedures for allocation of costs as added by the bill. The bill also clarifies that the deduction for regular tax purposes for personal exemptions is not allowed under the minimum tax, since a minimum tax exemption amount is provided. Further, the bill provides that only interest which is qualified residence interest for purposes of the regular tax may qualify as deductible housing interest for purposes of the minimum tax, clarifies that minimum tax investment interest and minimum tax passive losses do not include minimum tax housing interest, and provides that investment income for purposes of the minimum tax takes into account the minimum tax preferences and adjustments.

Book income.—The bill provides that an income statement that is filed with a Federal, state, or local government must be prepared for a substantial nontax purpose in order to be an applicable financial statement. Thus, an income tax return, franchise tax return or other similar return prepared for the purpose of determining any tax liability that is filed with Federal, State, or local authorities does not constitute an applicable financial statement. In addition, an income statement used by a government for statistical purposes only is not prepared for a substantial nontax purpose. The bill also provides that if a taxpayer has two or more financial statements with the same priority, the applicable financial statement shall be the one specified in regulations promulgated by the Secretary of the Treasury.

The gross amount of dividends (i.e. gross of any withholding taxes) received from a section 936 corporation, like dividends received from other nonconsolidated corporations, are included in the recipient's adjusted net book income. To the extent that the alternative minimum taxable income of the recipient is increased by reason of the inclusion of such dividends in adjusted net book income, the bill clarifies that a pro rata portion of withholding or income taxes is treated, for minimum tax purposes, as creditable foreign taxes paid by the recipient. The maximum amount of withholding or income taxes that may be treated as creditable foreign taxes is 50 percent of the taxes. However, this amount is reduced on a proportionate basis if a lesser amount of the dividends from the 936 corporation is taken into account in computing alternative minimum taxable income.

The bill also clarifies that if a taxpayer does not choose to take the benefit of section 901 with respect to income, war profits, or excess profits taxes imposed by a foreign country or possession of the United States, or is prohibited from taking the benefit of section 901 (i.e. taxes described in section 901(j)), adjusted net book income is reduced by only those taxes. That is, taxes which are not deductible for regular tax purposes (for example, withholding or income taxes imposed by a U.S. possession on dividends received from a section 936 corporation) are not deductible for this purpose. Similarly, the related income is to be reflected gross of any of these nondeductible taxes.

Adjusted current earnings.—The bill clarifies that the rule providing that income on an annuity contract is included in adjusted current earnings does not apply to a qualified annuity contract held under a plan described in section 403(a).

The bill provides an elective alternative to the general rule requiring depreciation for adjusted current income purposes to be computed using whichever of two methods yields deductions with the smallest present value. The two methods are the alternative depreciation system described in section 168(g) and the method used for book purposes. A taxpayer may instead elect to compute depreciation by taking a deduction equal to the amount necessary to increase the amount of accumulated depreciation (for adjusted current earnings purposes) on the property to the lesser of the accumulated depreciation allowed as of the end of the taxable year under either the alternative depreciation system described in section 168(g) of the the method used for book purposes. The election does not affect the depreciable basis allowed for purposes of the adjusted current earnings provisions.

A taxpayer may elect to use the alternative method for any taxable year beginning after 1989. The election applies to all property placed in service during that taxable year, and is irrevocable with respect to such property. If an election is made for the first taxable year for which the adjusted current earnings provision is effective, the election applies to all property placed in service during the taxable year and all previous taxable years. A taxpayer is not required to use the alternative method for property placed in service during any other taxable year by reason of having made the election for a prior taxable year.

The bill also provides a special rule in the case of any property subject to a lease where the income of the taxpayer for book purposes with respect to such property is determined without an allowance for depreciation. This situation may arise, for example, where a taxpayer leases property in a transaction that is treated for book purposes as a direct financing lease under FAS 13 (as amended).

In such a situation, the excess (if any) of the income from the lease for adjusted current earnings purposes (determined without regard to this provision or any other allowance for depreciation) over the income from the lease reported for book purposes is treated as the depreciation deduction determined with respect to such property for book purposes.

The adjusted current earnings depreciation for such property for any taxable year is to be determined using the alternative method described above. This use of the alternative method is not intended to be considered as an election of the alternative method applicable to all property placed in service during the taxable year.

The bill additionally provides that, in the case of property described in paragraphs (1), (2), (3), or (4) of section 168(f), the amount of depreciation allowable for regular tax purposes shall be treated as the amount allowable under the alternative system of section 168(g) for the purpose of determining adjusted current earnings depreciation. It is normally anticipated that the alternative method (described above) will be used and that such use will not be considered as an election of the alternative method applicable to all property placed in service during that taxable year.

Preferences.—The bill clarifies that the preference for bond interest only applies to tax-exempt bonds and the exception for refunding bonds includes both current and advance refundings. The bill also clarifies that the charitable contribution preference applies to trusts and estates as well as all other taxpayers

The bill provides that for purposes of the individual minimum tax, stock acquired pursuant to the exercise of an incentive stock option exercised after October 16, 1987, will be treated without regard to the rules of section 421. Instead the rules of section 83 will apply to the stock in determining the individual's alternative minimum taxable income. For example, if a taxpayer aquires stock pursuant to the exercise of an incentive stock option and disposes of the stock in the same taxable year, the tax treatment under the regular tax and the minimum tax will be the same; if the stock is disposed of in a disqualifying disposition in a subsequent taxable year, the "spread" between the option price and fair market value of the stock (determined in accordance with the rules of section 83) will be included in alternative minimum taxable income in the first taxable year and in taxable income (but not in alternative minimum taxable income) in the subsequent taxable year. In addition, if the stock acquired is subject to a lapse restriction, amounts will be included in the alternative minimum taxable income in accordance with the rules of section 83. (For options exercised on or before October 16, 1987, and disposed of in a disqualifying disposition, the minimum tax treatment and the regular tax treatment will be the same for both the year of exercise and the year of disposition.)

Investment tax credits.—The bill clarifies that the total amount of the general business credit allowable to a C corporation for a taxable year in which the regular tax exceeds the tentative minimum tax is determined as if the portion of the general business credit not attributable to the regular investment tax credit first offset the regular tax, and the regular investment credits (to the extent otherwise available) then reduced the net tax to 75 percent of the tentative minimum tax. This rule affects only the determination of amount of the general business credit allowable in a taxable year and does not change the usual ordering rules of section 38.

For example, assume a corporation had $100 million of regular tax, $80 million of tentative minimum tax, $30 million of regular investment tax credits (disregarding the cutback under section 49 for purposes of this example), and $20 million of other general business credits. $40 million of the general business credit would be allowed for the taxable year—$20 million by reason of the general rule of section 38(c)(1) allowing the general business credit to offset the excess of the net income tax over the tentative minimum tax and $20 million by reason of the special rule of section 38(c)(2) (as redesignated by the bill) allowing unused regular investment credits to offset 25 percent of the tentative minimum tax. The above result would occur without regard to the taxable years in which the various credits arose.

The bill also clarifies that the regular investment tax credit cannot be used in a taxable year to the extent that it, in conjunction with the NOL deduction and the foreign tax credit, would reduce the amount of tax payable by the taxpayer to less than 10 percent of the tentative minimum tax (determined without regard to the NOL deduction and foreign tax credits).

Foreign tax credits.—The bill clarifies that for purposes of determining whether any income is high-taxed income in applying section 904(d)(2) in computing the alternative minimum tax foreign tax credit, the alternative minimum tax rate is to be used in lieu of the regular tax rate.

Clerical amendments.—The bill makes numerous clerical amendments and corrects several cross references to these provisions.

Transitional provisions.—The bill provides that, for property that is depreciated under the new ACRS system during a taxable year of the taxpayer that begins before 1987, the new minimum tax depreciation (or pollution control facility amortization) rules apply to measure the preference, but the preference applies only to property to which the prior law rules of paragraphs (4) and (12) of section 57(a) applied. The bill also provides that in the case of a fiscal year trust or estate beginning in 1986 and ending in 1987, the prior law apportionment rules will apply notwithstanding that a beneficiary's taxable year begins in 1987. The bill also contains certain transition rules that were inadvertently amended or deleted in enrolling the Act.

VIII. Accounting Provisions (Sec. 6668 of the Bill)

1. Limitation on the use of the cash method of accounting (sec. 6668(a) of the bill, sec. 801 of the Reform Act, and secs. 448, 461, and 464 of the Code)

a. Definition of qualified personal service corporations

Present Law

Qualified personal service corporations are excepted from the general rule denying the use of the cash method of accounting to a C corporation or a partnership with a C corporation as a partner. A qualified personal service corporation is a corporation that meets both a function test and an ownership test. The function test is met if substantially all the activities of the corporation are the performance of services in the field or fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting.

The ownership test is met if substantially all (i.e., 95 percent) of the value of the outstanding stock in the corporation is owned, directly or indirectly, by employees performing services for the corporation in connection with the qualified services performed by the corporation, retired individuals who performed such services for the corporation or its predecessor(s), the estate of such an individual, or any other person who acquired stock by reason of the death of such an employee (for the two-year period beginning with the death of such employee).

A special rule is provided allowing the common parent of an affiliated group (within the meaning of section 1504(a)) to elect to treat all members of such affiliated group as one taxpayer for the purpose of determining if the ownership test is met, provided that substantially all of the activities of the members of such affiliated group involve the performance of services in the same field satisfying the function test.

Explanation of Provision

The bill provides that, for the purpose of determining if a corporation meets the ownership test, indirect ownership of stock is to be taken into account only where stock is owned indirectly through one or more partnerships, S corporations, or qualified personal service corporations. Thus, other forms of indirect stock ownership (e.g., as a result of attribution between family members or a holding company) are not considered in determining if the ownership test is satisfied. Stock that is owned by a partnership, S corporation, or qualified personal service corporation is considered to be owned by its owners in the same proportion as their ownership of the partnership, S corporation or qualified personal service corporation.

The bill also provides that a common parent of an affiliated group may elect to treat all members of such group as one taxpayer for the purpose of determining if the ownership test is met where substantially all of the activities of such affiliated group involve the performance of services in the same field satisfying the function test. Thus, if substantially all of the activities of the affiliated group, taken as a whole, are the performance of services in a field satisfying the function test, an election is available to apply the ownership test to the group as a whole. The function test, however, must still be applied to each separate corporation.

b. Requirement that tax shelters in oil and gas must pay cash before year end

Present Law

Under section 461(i), in the case of tax shelters, no deduction is allowed with respect to an item until there has been economic performance with respect to that item. Under a special rule applicable to tax shelters in oil and gas, economic performance with respect to drilling of an oil or gas well is deemed to occur at the time of spudding.

Explanation of Provision

When the special spudding rule for economic performance was adopted by Congress in the Deficit Reduction Act of 1984, economic performance was deemed to occur at the time of spudding of an oil or gas well where the taxpayer had paid for the drilling costs prior to the close of the taxpayer's year. The Reform Act inadvertently removed the requirement that the taxpayer must have paid for the drilling costs by the close of the taxpayer's year in order for the special spudding rule to apply. The bill provides that tax shelters in oil and gas must have paid for the drilling activity before the end of its taxable year in order for spudding to be considered as economic performance.

In the case of a partnership, a partner's deduction of drilling expenses that are treated as economically performed by reason of the spudding rule is limited to the partner's cash basis in the partnership. A partner's cash basis is equal to the adjusted basis of its interest in the partnership, determined without regard to amounts related to certain borrowings. These amounts are (1) any liability of the partnership, (2) any amount borrowed by the partner with respect to the partnership which was either arranged by the partnership or any participant in the organization, sale or management of the partnership, and (3) any amount borrowed by the partner if such borrowing was secured by the assets of any partnership.

c. Limitations on farming deductions

Present Law

Under Code section 464(a), farming syndicates are allowed a deduction for amounts paid for feed, seed, fertilzer, or other similar farm supplies no earlier than the taxable year in which such feed, seed, fertilizer, or other supplies actually are used for consumed.

Under Code section 464(b), farming syndicates are required to capitalize the cost of poultry purchased for use in a trade or business and to deduct such cost ratably over the lesser of 12 months or the useful life of such poultry in the trade or business. In addition, a farming syndicate may deduct only the cost of poultry purchased for sale in the taxable year in which the poultry is disposed of.

The Reform Act applies Code section 464(a) and 464(b) to certain persons prepaying 50 percent or more of certain farming expenses, with respect to the portion of such expenses exceeding 50 percent.

The Act denies the use of the cash method of accounting to any tax shelter. The definition of tax shelter for this purpose includes all farming syndicates.

Explanation of Provision

The bill provides that sections 464(a) and 464(b) shall not apply to farming syndicates in taxable years beginning after December 31, 1986, because these rules are duplicated by the rules of the Reform Act that require tax shelters to use an accrual method of accounting.

2. Capitalization rules for inventory, construction, and development costs (sec. 6668(b) of the bill, sec. 803 of the Reform Act, and section 263A of the Code)

Present Law

In general

The uniform cost capitalization rules apply to the manufacture or construction of all tangible property and to the purchasing and holding property for resale. Exceptions to these rules are provided for property product by the taxpayer for personal use, research and experimental costs allowable as a deduction under section 174, certain development and other costs of oil and gas wells and mineral property deducible under section 263(c), 616(a), or 617(a), property produced pursuant to a long-term contract, and the production of timber and certain ornamental trees.

Simplified method for retailers

Taxpayers with gross receipts in excess of $10 million who acquire property for resale are required to apply the uniform capitalization rules with respect to such property. The uniform capitalization rules require that all direct costs of such property and such property's proper share of those indirect costs, part or all of which are allocable to such property, be absorbed into the inventory costs of the property, rather than currently expensed. Included in the costs required to be absorbed into inventory cost are off-site storage costs and related handling costs. The Secretary of the Treasury is directed to prescribe regulations providing for simplified procedures for the application of the uniform capitalization rules in the case of property acquired for resale.

Capitalization of interest

Interest costs are subject to special rules. Capitalization of interest is required only if the taxpayer is engaged in the manufacture or construction of property (i.e., resellers are exempt), and only if the property produced is real property or personal property that is long-lived or has an extended production period. Interest costs are allocable to the production or construction of property if they are directly attributable to production expenditures incurred in producing the property, or could have been avoided if the production expenditures had not been incurred. Interest incurred or continued in connection with property used to produce property is also subject to capitalization.

Special rules for farmers

Special rules also apply to the production of farm products. In general, the uniform capitalization rules apply to such production only if the product has a preproductive period of more than two years. The special rules do not apply to taxpayers required to use an accrual method of accounting under section 447 or 448. Except for taxpayers using the annual accrual method of accounting, taxpayers required to use an accrual method of accounting must capitalize preproductive expenses.

Certain farmers otherwise required to capitalize preproductive period costs may elect to deduct them currently, provided the alternative cost recovery system is used on all farm assets and the expensed costs are recaptured upon disposition of the product. The election is not available to taxpayers required to use the accrual method of accounting or engaged in the production of pistachios. In addition, costs incurred in replanting edible crops following loss or damage due to freezing temperatures, disease, drought, pests, or casualty may be deducted currently. This exception may apply to costs incurred by persons other than the taxpayer who incurred the loss or damage, provided (1) the taxpayer who incurred the loss or damage retains an equity interest of more than 50 percent in the property on which the loss or damage occurred and (2) the person claiming the deduction materially participates in the planting or maintenance of the property during the four-taxable year period beginning with the year of the loss or damage.

Effective dates

In the case of inventories, the provisions generally are effective for taxable years beginning after December 31, 1986. In the case of self-constructed property and noninventory property held for sale, the rules apply to costs incurred after December 31, 1986, unless incurred with respect to property on which substantial construction (whether by the taxpayer or by another person) occurred before March 1, 1986.

Explanation of Provision

In general

The bill adds to the list of costs specifically exempted from the uniform capitalization rules costs incurred in connection with oil and gas wells or mineral property that are subject to amortization pursuant to section 291(b)(2), 263(c), 263(i), 616, or 617, and costs (other than circulation expenditures) subject to ten-year amortization under section 59(e). It is clarified that overhead expenses properly allocable to intangible drilling costs are to be treated in the same manner as such intangible drilling costs for the purpose of determining whether such costs are exempted from the uniform capitalization rules.

Simplified method for retailers

The Secretary of the Treasury was directed in the Tax Reform Act of 1986 to issue regulations providing for simplified procedures for the application of the uniform capitalization rules in the case of property acquired for resale. It is anticipated that these regulations will provide a method for computing allocation ratios for the purpose of assigning a portion of total costs to ending inventory or cost of sales. The allocation ratio for assigning storage costs and related handling costs is expected to be determined by dividing the gross amount of such costs by the sum of beginning inventory balances plus purchases for the taxable year.

Capitalization of interest

The bill also clarifies that, in determining the amount of interest that must be capitalized in connection with an asset used to produce property, the methods applied under the general interest allocation rules are applied to the full cost of the asset.[1] Accordingly, any interest specifically traceable to such an asset must first be allocated to the produced property; interest on other debt of the taxpayer is then allocated to the extent required under the avoided cost method.[2]

Finally, the bill clarifies that a cost is subject to capitalization under this provision only to the extent it is otherwise taken into account in computing taxable income for any taxable year. Thus, for example, the portion of a taxpayer's interest expense that is allocable to personal loans, and hence is disallowed under section 163(h), may not be included in a capital or inventory account and recovered through depreciation or amortization deductions, as a cost of sales, or in any other manner.

Special rules for farmers

The special rule for costs incurred by persons other than the taxpayer in connection with replanting a crop of the taxpayer following loss or damage due to freezing temperatures, etc., is modified. Under the bill, such costs may be deducted without regard to whether they were incurred (or the persons' material participation occurs) within the four-taxable year period following the loss or damage.

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[1] If an asset is not used exclusively in the production of a single property, the total interest cost associated with the asset is allocated among the various properties produced.

[2] To avoid double counting, any interest allocated to property under this rule is not again allocated to the property under the general interest allocation rule. For example, interest allocated under the general rule to depreciation on an asset used to produce property, which would be a production expenditure that would "attract" interest under the avoided cost method, might otherwise duplicate interest allocated under this special rule for production-related assets.

Many taxpayers using the annual accrual method of accounting, other than taxpayer's engaged in the trade or business of growing sugar cane, were required under section 278 of prior law to capitalize preproductive expenses (e.g., citrus growers). The Reform Bill repealed section 278. The bill restricts the taxpayers that use the annual accrual method of accounting that may expense preproductive expenses to taxpayers engaged in the trade or business of farming sugar cane.

3. Long-term contracts (sec. 6668(c) of the bill, sec. 804 of the Reform Act, and sec. 460 of the Code)

Present Law

Taxpayers engaged in the production of property under a long-term contract must compute income from the contract under either the percentage of completion method or the percentage of completion-capitalized cost method. Under the percentage of completion method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (1) the gross contract price and (2) the percentage of the contract completed during the taxable year. The percentage of a contract completed during the taxable year is determined by comparing costs incurred with respect to the contract during the year with the estimated total contract costs.

In the taxable year in which a contract reported under the percentage of completion method is completed, a determination is made whether the taxes paid with respect to the contract in each year of the contract were more or less than the amount that would have been paid if gross income had been computed by using the actual gross contract price and the actual total contract costs, rather than the anticipated contract price and costs. Interest must be paid by the taxpayer if, applying this "look-back" method, there is an underpayment by the taxpayer with respect to a taxable year. Similarly, interest must be paid to the taxpayer by the Internal Revenue Service if there is an overpayment.

Under the percentage of completion-capitalized cost method, the taxpayer must take into account 40 percent of the items with respect to the contract under the percentage of completion method. The remaining 60 percent of the items under the contract must be taken into account under the taxpayer's normal method of accounting (e.g., completed contract method, accrual shipment method).

Costs that directly benefit, or are incurred by reason of, a taxpayer's long-term contract activities must be allocated to its long-term contracts in the manner provided in the Treasury regulations under section 451 for extended period long-term contracts. This method of allocation is required irrespective of whether the contract is reported under the percentage of completion-capitalized cost method or the percentage of completion method. While costs may be deducted in the year incurred if they relate to a contract (or portion of a contract) reported under the percentage of completion method, whether costs are allocable to such a contract is nonetheless relevant because it affects the determination of the percentage of the contract completed during the year.

Explanation of Provision

The bill authorizes the Secretary of the Treasury to prescribe a simplified procedure for the allocation of costs to a contract for purposes of applying the percentage of completion method. Thus, for example, the Secretary may permit the determination of the percentage of a contract completed during the taxable year to be based on fewer costs than are taken into account for purposes of applying the completed contract method or other long-term contract method of accounting. This simplified method may not be used by taxpayers using the percentage of completion-capitalized method for accounting for long-term contracts.

The bill also provides that, in applying the look-back method, amounts received or accrued after completion of the contract are taken into account by discounting such amounts to their value as of the completion of the contract. The Federal mid-term rate as of the time the amount was received is the applicable discount rate.

4. Taxable years of certain entities (sec. 6668(e) of the bill, sec. 806 of the Reform Act, and secs. 706, 1379, 441, and 267 of the Code)

a. Majority interest taxable years

Present Law

A partnership may not have a taxable year other than the taxable year of the partners owning a majority interest in partnership profits and capital. If partners owning a majority of partnership profits and capital do not have the same taxable year, the partnership adopt the same taxable year as its principal partners. If the principal partners of the partnership do not have the same taxable year and no majority of its partners have the same taxable year, the partnership must adopt the calendar year or such other period as the Secretary of the Treasury may prescribe by regulations.

The majority interest rule does not apply unless the period that constitutes the taxable year of partners owning a majority interest in partnership profit and capital has been the same for the three-taxable-year period of such partners ending on or before the beginning of such taxable year of the partnership. If the partnership has not been in existence for all of such three-taxable-year period, the period that constitutes the taxable year of the partners owning a majority interest in profits and capital must have been the same for the taxable years of such partners ending with or within the period of the partnership's existence.

Explanation of Provisions

The bill provides that a partnership may not have a taxable year other than its majority interest taxable year. If the partnership does not have a majority interest taxable year, it may not have a taxable year other than the taxable year of all of its principal partners. If the partnership does not have a majority interest taxable year and all of its principal partners do not have the same taxable year (or the partnership has no principal partners), the partnership may not have a taxable year other than the calendar year, unless the Secretary of the Treasury, by regulations, prescribes another period.

The majority interest taxable year is the taxable year (if any) that, on the testing day, constituted the taxable year of one or more partners having (on the testing day) an aggregate interest in partnership profits and capital of more than 50 percent. Generally, the testing day is the first day of the partnership taxable year. The Secretary of the Treasury may provide that an alternate, representative period be used as the testing day, rather than the first day of the taxable year, if such period is more representative of the ownership of the partnership. A partnership that is required to change its taxable year to its majority interest taxable year is not required to change to another taxable year for either of the two taxable years following the year of change.

b. Sequence of required changes in taxable years

Present Law

The requirement of the Reform Act that partnerships conform their taxable years to the taxable years of their owners does not take into consideration changes in taxable years of such owners that also may be required by the Act. Thus, such partnership may be required to change their taxable years several times as the taxable years of their owners change.

Explanation of Provisions

The bill provides that, except as otherwise provided in the regulations issued by the Treasury Regulations, the changes in taxable years of other persons required to change taxable years are to be taken into account in determining the required taxable year of a partnership.

c. Personal service corporations

Present Law

A personal service corporation is required by the Reform Act to adopt a calendar year, unless it establishes to the satisfaction of the Secretary of the Treasury a business purpose for a different taxable year. A personal service corporation is a corporation the principal activity of which is the performance of personal services if services are substantially performed by employee-owners.

Explanation of Provisions

The bill provides that a corporation is not considered to be a personal service corporation for this purpose unless more than 10 percent of the stock (by value) in such corporation is held by employee-owners.

The bill further provides that, if a corporation is a member of an affiliated group filing a consolidated return, all members of such group shall be taken into account in determining whether such corporation is a personal service corporation.

d. Common trust funds.

Present Law

The Reform Act did not address the taxable year to be used by a common trust fund taxed under section 584.

Explanation of Provision

Consistent with the rules requiring use of a calendar year for other pass-through entities (e.g., partnerships, S corporations, trusts), the bill requires the taxable year of a common trust fund be the calendar year. If a common trust fund is required to change taxable years as a result of this provision, and as a result of such change a participant in such common trust fund is required to include items from more than one taxable year of the common trust fund in any of the participant's taxable years, the items from the short taxable year of the common trust fund may be included in income by the participant ratably over a four-taxable-year period, unless the participant elects to include all such income currently.

e. Effective date.

Present Law

The Reform Act provided that, if any partner or shareholder of an S corporation is required to include the items from more than one taxable year of the partnership or S corporation in any one taxable year, income in excess of expenses for the short taxable year of the partnership or S corporation is to be taken into account ratably in each of the first four taxable years (including such short taxable year) beginning after December 31, 1986, unless the partner or shareholder of the S corporation elects to include all such income in the short taxable year.

The Internal Revenue Service has issued a revenue procedure which sets forth rules under which the Service will permit electing S corporations to adopt taxable years other than a calendar year. Rev. Proc. 83-25, 1983-1 C.B. 689. Under the so-called "25-percent test" of that revenue procedure, an electing S corporation generally may adopt, retain, or change to a taxable year if, among other tests, 25 percent or more of the gross income of the taxpayer is realized in the last two months of that year.

Explanation of Provision

The bill clarifies that the four year spread provided by the Reform Act for partners and shareholders in S corporations is only applicable to changes in taxable years that are required by the Reform Act for the first taxable year beginning after December 31, 1986. The bill clarifies that the four year spread is made at that partner or shareholder level, rather than at the level of the partnership or S corporation.

The adjusted basis of a partner in its partnership interest or of an S corporation shareholder in his stock is determined as if all of the income to be taken into account over the four year spread period were included in gross income in the first taxable year.

Thus, current distribution of an amount equal to the amount of income attributable to the partner or S corporation shareholder in the short taxable year will not result in capital gain, unless the distribution would have had such an effect had there been no four year spread. If any interest in a partnership or stock in an S corporation is disposed of before the last taxable year in the spread period, any income attributable to the interest or stock disposed of that remains to be recognized pursuant to the spread is included in the gross income in the same taxable year as the interest or stock is disposed of.

The bill provides that the four year spread for income attributable to a short taxable year will apply only once in the case of a passthrough or tiered item.

The bill provides that the Internal Revenue Service is not required to permit taxpayers to have an automatic change of a taxable year. Thus, taxpayers meeting the "25-percent test" of Rev. Proc. 83-25 are not automatically permitted to adopt or change to a year allowed under that revenue procedure.

5. Treatment of installment obligations (sec. 6668(f) and 6668(g) of the bill, secs. 811 and 812 of the Reform Act, and secs. 453 and 453C of the Code)

Present Law

In applying the proportionate disallowance rule under present law, the installment percentage of a taxpayer's average quarterly indebtedness generally is treated as a payment on the taxpayer's applicable installment obligations. The taxpayer's year-end indebtedness may be used instead of average quarterly indebtedness if the taxpayer has no applicable installment obligations arising from dealer sales outstanding at any time during the taxable year. In addition, in applying the proportionate disallowance rule, all assets and indebtedness of certain related taxpayers are aggregated.

Under present law, applicable installment obligations include installment obligations arising from certain specified types of sales, which installment obligations are held by the seller or a member of the same affiliated group (within the meaning of section 1504(a) without regard to section 1504(b)) as the seller. Obligations arising from sales of personal property pursuant to a revolving credit plan or obligations arising from the sale of publicly traded property may be treated as applicable installment obligations. Under present law, personal use property and indebtedness secured primarily by such property are not taken into account for purposes of applying the proportionate disallowance rule of section 453C to applicable installment obligations arising from dealer sales.

Under present law, taxpayers who are required to change their method of accounting for sales pursuant to a revolving credit plan because of section 812 of the Reform Act must take into income any adjustment arising under section 481 over a period of four years, with specified percentages for each of the four years.

Explanation of Provisions

The bill provides that taxpayers who have no applicable installment obligations outstanding at year-end other than applicable installment obligations arising from non-dealer sales, must use their year-end indebtedness, rather than their average quarterly indebtedness for purposes of applying the proportionate disallowance rule. The bill provides that personal use property and indebtedness secured primarily by such property are not taken into account for purposes of applying the proportionate disallowance rule of section 453C to applicable installment obligations arising from non-dealer sales. The bill also grants authority to the Treasury Department to issue regulations modifying the rules requiring aggregation of the assets and indebtedness of certain related taxpayers.

The bill clarifies that the term "applicable installment obligation" includes installment obligations arising from certain specified types of sales, which installment obligations are held by the seller or any person if the basis of such obligation in the hands of such person is determined (in whole or in part) by reference to the basis of such obligation in the hands of another person and such obligation was an applicable installment obligation in the hands of such other person. Thus, for example, if an applicable installment obligation is transferred to a partnership or a trust in a nonrecognition transaction and the partnership or trust has a carryover basis in the installment obligation, then the obligation is treated as an applicable installment obligation in the hands of the partnership or trust.

The bill also clarifies that installment obligations arising from the sale of personal property pursuant to a revolving credit plan or from the sale of publicly traded property are not treated as applicable installment obligations. Thus, such installment obligations are not subject to the proportionate disallowance rule. In addition, the bill clarifies that the provision denying the use of the installment method for sales of publicly traded property applies with respect to sales of such property after December 31, 1986.

In addition, the bill clarifies how the proportionate disallowance rule is applied with respect to applicable installment obligations arising after February 28, 1986, but in a taxable year prior to the first taxable year ending after December 31, 1986. The bill specifies that any such applicable installment obligations are treated as arising on the first day of the first taxable year of the taxpayer ending after December 31, 1986.

The bill provides that if a taxpayer's last taxable year beginning before January 1, 1987, was the taxpayer's first taxable year in which sales were made under a revolving credit plan, then all adjustments under section 481 are taken into account in the taxpayer's first taxable year beginning after December 31, 1986. The bill also provides that the adjustment under section 481 required by the repeal of the installment method for revolving credit plans is to be taken into account no slower than the rate of contraction of the revolving credit installment obligations that were outstanding as of the close of the last taxable year beginning before January 1, 1987.

The bill also provides that if a taxpayer sells any receivables that arose pursuant to a revolving credit plan and that were taken into account in computing the adjustment under section 481 relating to the change from the installment method to the accrual method, then the taxpayer may not recognize any loss on the sale of such receivables. If a loss is realized on any such sale, however, then the taxpayer may reduce the aggregate amount of the adjustment under section 481 for the fourth taxable year beginning after December 31, 1986, by the amount of such loss; to the extent that the loss exceeds the aggregate adjustment for such fourth taxable year, then the adjustment for the third taxable year is reduced, and so on.

Further, the bill corrects certain clerical and technical errors.

6. Income attributable to utility services (sec. 6668(h) of the bill, sec. 821 of the Reform Act, and sec. 451 of the Code)

Present Law

Accrual basis taxpayers are required to recognize income attributable to the furnishing or sale of utility services to customers not later than the taxable year in which such services are provided to the customer. For taxable years beginning after December 31, 1986, the year in which utility services are provided may not be determined by reference to the time the customer's meter is read or to the time that the customer is billed (or may be billed) for such services.

For any taxable year beginning before August 16, 1986, a method of accounting that took into account income from the furnishing or sale of utility services on the basis of the period in which the customer's meters were read is deemed to be proper for Federal income tax purposes.

Explanation of Provision

The bill provides that, for taxable years beginning on or after August 16, 1986, and before January 1, 1987, a method of accounting that took into account income from the furnishing or sale of utility services on the basis of the period in which the customer's meters were read is deemed to be proper for Federal income tax purposes, provided such income was treated in the same manner for the preceding taxable year. No inference is intended as to whether or not such method is proper if the method was actually used by the taxpayer for the preceding taxable year.

In providing that a method of accounting which takes into account income from the providing of utility services on the basis of the period in which the customers' meters are read will be deemed proper for Federal income tax purposes for any period, no inference of propriety was intended for any method that did not strictly adhere to the meter reading method for all customers of the utility. In addition, no inference was intended with regard to other questions of law, including but not limited to the treatment of prepaid income amounts for the provision of utility services at a future date, the treatment of deposits made by utility customers, or the treatment of amounts received or accrued by the utility under a "budget-billing" procedure.

IX. Financial Institutions (Sec. 6669 of the Bill)

1. Limitations on bad debt reserves (sec. 6669(a) of the bill, sec. 901 of the Reform Act, and sec. 46(c)(4) of the Code)

Present Law

Section 901 of the Act reduced that portion of taxable income that thrift institutions (mutual savings banks, domestic building and loan associations, and cooperative banks) may deduct as an addition to reserves for bad debts from a maximum of 40 percent to eight percent. In addition, an institution otherwise meeting the definition of a thrift institution was required to hold at least 60 percent of its assets in qualifying assets in order to meet the definition of a thrift institution.

Prior and present law limits the amount of investment eligible for the investment tax credit in the case of a thrift institution to 50 percent of the amount otherwise allowable. Where a thrift institution is the lessee of property that is eligible for the investment tax credit, the lessor is treated as a thrift institution with respect to such property, unless the thrift institution has elected to compute its deduction for bad debts using the experience method. Such an election is binding on the thrift institution for all subsequent years.

Explanation of Provision

The bill provides that an election by a leasee thrift institution to use the experience method of computing its deduction for bad debts shall terminate effective with respect to the first taxable year of the electing organization beginning after 1986 and during which such organization (or any successor organization) was not the lessee under any lease of regular investment tax credit property. Regular investment tax credit property is any section 38 property if the regular percentage applied to such property and the amount of qualified investment with respect to such property would have been reduced but for the election by the organization.

The effect of the provision is to allow a thrift institution that had committed to the use of the experience method of accounting for bad debts in order to avoid certain reductions in investment tax credit to use the percentage of income method in taxable years beginning after 1986, provided the thrift institution is not a lessee of property that was eligible for investment tax credit without reduction as a result of the prior election.

2. Interest on debt used to purchase or carry tax-exempt obligations (sec. 6669 of the bill, sec. 902 of the Act, and secs. 265 and 291 of the Code)

Present Law

The Act denies banks, thrift institutions, and other financial institutions a deduction for that portion of the taxpayer's otherwise allowable interest expense that is allocable to tax-exempt obligations acquired by the taxpayer after August 7, 1986 (sec. 265(b)).[1] The portion of interest disallowed is equivalent to the ratio of (1) the average adjusted basis during the taxable year of tax-exempt obligations held by the financial institution and acquired after August 7, 1986, to (2) the average adjusted basis of all assets held by the financial institution. A 20-percent disallowance continues to apply (as under pre-1986 law) with respect to tax-exempt obligations acquired between January 1, 1983, and August 7, 1986.

An exception to the proportional disallowance rule is provided for qualified tax-exempt obligations acquired by a financial institution. Qualified tax-exempt obligations include any tax-exempt obligation which (1) is not a private activity bond, as defined under Title XIII of the Act,[2] and (2) is issued by an issuer which reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than private activity bonds, as defined above) during the calendar year. Qualified tax-exempt obligations must be designated as such by the issuer; not more than $10 million of obligations may be so designated for any calendar year.

For purposes of applying the limitations with respect to qualified tax-exempt obligations, an issuer and all subordinate entities are treated as one issuer.

Qualified tax-exempt obligations are treated as if acquired by the financial institution on August 7, 1986. Interest allocable to such obligations thus remains subject to the 20 percent disallowance rule contained in pre-1986 law.

Explanation of Provisions

The bill makes several amendments to the exception for qualified tax-exempt obligations, as follows:

Application of $10 million limit

The bill clarifies that, in applying the $10 million limitation with respect to qualified tax-exempt obligations, all tax-exempt obligations (other than private activity bonds, as defined above) which the issuer reasonably anticipates to issue during the calendar year are taken into account. Thus, only an issuer that reasonably anticipates to issue $10 million or less of such obligations during the calendar year (including designated and undesignated issues) may designate any of these obligations for purposes of the exception.

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[1] This rule is applied after the general disallowance rule applicable to all taxpayers (sec. 265(a)(2)).

[2] For purposes of this exception only, qualified 501(c)(2) bonds (as defined in Title XIII of the Act) are not treated as private activity bonds. Additionally, certain bonds receiving transtitional exceptions under Title XIII of the Reform Act, and which would not have been industrial development bonds (IDBs) or private loan bonds under prior law, are not treated as private activity bonds.

Treatment of composite issues

The bill specifices the treatment of composite issues (i.e., combined issues of bonds for different entities) for purposes of the exception. An issue is a composite issue if the separate lots are sold under a common marketing arrangement that effectively provides the issuers of the separate lots access to the capital markets in a manner similar to the issuance of one issue. In order for separate lots to be treated as a composite issue, all lots need not have the same collateral or security for the lots or have cross-collaterization among lots.

Under the bill, composite issues qualify for the exception only if the requirements of the exception are met (1) with respect to the composite issue as a whole (determined by treating the composite issue as a single issue), and, additionally, (2) with respect to each separate lot of obligations which is a part of the issue (determined by treating each separate lot of obligations as a separate issue). Thus, a composite issue may qualifiy for the exception only if the composite issue itself does not exceed $10 million, and if, additionally, each issuer benefiting from the composite issue reasonably anticipates to issue not more than $10 million of tax-exempt obligations (other than private activity bonds, as described above) during the calendar year, including bonds issued through the composite arrangement. *See also*, the conditions under which bonds of different issuers are aggregated for purposes of the $10 million limit, described below.

Aggregation of issuers

The bill clarifies the operation of the provision under which an issuer and all subordinate entities are aggregated for purposes of the $10 million limitation. The following rules are provided:

> (1) An issuer and all entities which issue bonds "on behalf of" [3] that issuer are to be treated as one issuer. Nonetheless, where an entity issues bonds "on behalf of" two or more issuers, the issuers may irrevocably agree in advance of the issue on an allocation of the issue between the issuers for the purposes of determining the amount of bonds that each issuer is considered to have issued, so long as the allocation bears a reasonable relationship to the benefits received by the entities from the bonds.
>
> (2) If an issuer is subordinate to another entity but does not issue bonds on behalf of another entity, bonds issued by the subordinate entity are taken into account in applying the $10 million limitation to the entity to which it is subordinate.
>
> (3) If an entity is formed or (to the extent provided in Treasury regulations) availed of for purposes of avoiding the $10 million limitation, such entity and any other entity or entities) purporting to benefit from this device are treated as one issuer.

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[3] *e.g.*, Rev. Rul. 63-20, 1963-1 C.B. 24.

Treatment of refunding bonds

Under the bill, the treatment of refunding bonds also is clarified. Specifically, the following rules would apply to refundings.

Treatment of refunding obligations in determining whether issuer reasonably expected to issue more than $10 million.—Any bond whose proceeds are used to refund (other than advance refunding) a previously issued bond is not to be taken into account for purposes of determining whether a governmental unit reasonably expected to issue more than $10 million of non-private purpose obligations.

Refunding of obligations that originally were treated as qualified tax-exempt obligations.—Any bond whose proceeds are used to refund (other than to advance refund) a previously issued obligation which was a qualified tax-exempt obligation is itself treated as a qualified tax-exempt obligation if (1) the refunded bond was designated, qualified for, and was taken into account under, under the $10 million limitation when issued,[4] (2) the aggregate face amount of the issue of which the refunding bond is a part does not exceed $10 million, (3) except in the case of refunding of bonds having a weighed average maturity of 3 years or less, the weighted average maturity of the refunding issued does not exceed the weighted average maturity of the refunded bonds, and (4) no bonds which is part of the refunding issue has a maturity in excess of 30 years (measured from the date of issuance of the original issue of the refunded bonds).

Refundings of obligations that originally not treated as qualified tax-exempt obligations.—Any bond whose proceeds are used to refund a previously issued obligation which was not a qualified tax-exempt obligation (e.g., the bond was issued before August 8, 1986 or an advance refunding) may be a qualified tax-exempt obligation if the refunding bond otherwise qualifies as a qualified tax-exempt obligations (i.e., (1) the refunded bond was not a private purpose bond (including any industrial development bond or private loan bond as determined under the rules prior to the Tax Reform Act of 1986), (2) the issuer reasonably expected to issue not more than $10 million of bonds (excluding any refunding bond, but including any advance refunding bonds), (3) the issuer designated the bond as part of its $10 million of designated bonds for that year, and (4) the issue of which the refunding bond is a part in not more than $10 million).

Designation of certain bonds issued in reliance on House bill

The bill specifies that only obligations issued after August 7, 1986, may be designated for purposes of the exception. For obligations issued after August 7, 1986, and before January 1, 1987, the period of making a designation is not to expire before January 1, 1988.

A special rule is provided for certain obligations issued before August 8, 1986, in reliance on a similar exception contained in the

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[4] Thus, in order for a bond to meet these requirements, the refunded bond must be (1) issued after August 7, 1986, (2) issued by an issuer that reasonably expected to issue not more than $10 million in non-private purpose obligations that year, and (3) designated by the issuer as part of its $10 million of designated bonds that year.

House version of the 1986 Act.[5] Under this rule, if (1) an obligation was issued after December 31, 1985, and before August 8, 1986, (2) when the obligation was issued, the issuer designated that it intended the obligation to qualify under section 802(e)(3) of the House bill, and (3) the issuer reaffirms its election under the 1968 Act, then the obligation is treated as issued on August 8, 1986.

Effective Dates

The provisions regarding aggregation of entities, refunding, and composite issues are effective for obligations issued after June 30, 1987. (At the election of the issuer, these provisions are effective as if included in the 1986 Act). Other provisions are effective as if included in the 1986 Reform Act.

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[5] H.R. 3838 (99th Congress), as passed by the House of Representatives on December 17, 1985.

X. Insurance Provisions (Secs. 6670 and 6678 (g) and (i))

1. Treatment of certain market discount bonds (sec. 6670(a) of the bill and sec. 10210(d) of the Reform Act)

Present Law

The Reform Act repealed the prior-law 28 percent alternative tax rate for corporate long-term capital gains, for years for which the new corporate tax rates are fully effective (i.e., taxable years beginning on or after July 1, 1987). Thus, corporate net capital gain for such years is taxed at regular corporate rates (i.e., generally a maximum 34 percent rate under the Reform Act). For taxable years that include periods prior to the time the new rates are fully effective, the alternative tax rate under the Reform Act on gain properly taken into account under the taxpayer's method of accounting after December 31, 1986, is 34 percent. These rules apply to all items of long-term capital gain, including gain attributable to market discount on bonds issued before July 19, 1984, which was treated as long-term capital gain under the transition rules of the Deficit Reduction Act of 1984.

The Deficit Reduction Act of 1984 generally required income attributable to market discount to be treated as ordinary income rather than capital gain on disposition of a bond (Code sec. 1276). However, the 1984 Reform Act grandfathered market discount gain on bonds issued before July 19, 1984.

Under the Reform Act, a special rule is provided for gain with respect to certain bonds of certain specified life insurance companies. Pursuant to this rule, gain representing market discount recognized by such companies on the redemption at maturity of any bond which was issued before July 19, 1984, and acquired by the company on or before September 25, 1985, is subject to tax at the rate of 28 percent.

Explanation of Provision

The bill extends the special rule under the Reform Act to all life insurance companies with a modification of the tax rate to ensure that the extension has a neutral budget effect. Under the bill, the tax rate on gain subject to the special rule is 31.6 percent, rather than 28 percent.

2. Status of certain organizations providing commercial-type insurance (sec. 6670(b) of the bill and sec. 1012 of the Reform Act)

Present Law

Under present law, an organization described in section 501(c) (3) or (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. In the case of such a tax-exempt organization, the activity of providing commercial-type insurance is treated as an unrelated trade or business but, in lieu of the usual tax on unrelated trade or business taxable income, the unrelated trade or business activity is taxed under the rules relating to insurance companies (subchapter L of the Code).

Commercial-type insurance does not include insurance provided at substantially below cost to a class of charitable recipients. Commercial-type insurance also does not include health insurance provided by a health maintenance organization (i.e., any health maintenance-type organization, tax-exempt under prior law, which is substantially similar to a Federally chartered health maintenance organization), if such health insurance is of a kind customarily provided by such organizations and is incidental to the organization's principal activity of providing health care. Commercial-type insurance also does not include property and casualty insurance provided by certain church organizations or conventions or associations of churches, if certain requirements are met.

The provision does not apply to certain organizations, including Delta Dental Plans Association and the Missouri Hospital Association.

Explantion of Provision

The exceptions from the provision for Delta Dental Plans Association and for the Missouri Hospital Association are restated to apply to Delta Dental Plans Association organizations and to the Missouri Hospital Plan, respectively.

The bill also provides Treasury regulatory authority to prescribe rules providing proper adjustments in the case of organizations that have a fiscal taxable year and that become subject to tax by reason of the provision, if the organization has a short taxable year that begins during 1987 by reason of rules requiring property and casualty insurance companies generally to have a calendar taxable year.

3. Inclusion in income of 20 percent of unearned premium reserve (sec. 6670(c) of the bill, sec. 1021 of the Reform Act, and sec. 832(b)(7) of the Code)

Present Law

Present law, as amended by the Reform Act, provides that a property and casualty insurance company generally is required to reduce its deduction for increases in unearned premiums by 20 percent. In addition, such companies are required to include in income 20 percent of the unearned premium reserve outstanding at the end of the most recent taxable year beginning before January 1, 1987, ratably over the 6 taxable years following such year.

The provision requiring ratable inclusion of the pre-1987 unearned premium reserve applies to a company without regard to whether the company had computed its taxable income by taking into account additions to an unearned premium reserve. Thus, the ratable inclusion rule applies, under the Reform Act, to organizations that were exempt from Federal income tax prior to 1987 and to small companies that were taxed solely on investment income.

The Reform Act did not provide special rules for reciprocal insurers.

Explanation of Provision

Treatment of certain formerly exempt companies.—The bill provides that if, at all times prior to its 1986 taxable year, a company was exempt from tax under section 501(a) by virtue of being described in a paragraph of section 501(c), or was a small company subject to tax only on investment income, then the ratable inclusion rule does not apply. This clarification reflects the intent that no inclusion of prior reserve amounts is appropriate if the company received no tax benefit from the reserve amounts due to its former fully or partially tax-exempt status.

Phase-in treatment.—The bill also adjusts the period over which inclusion of 20 percent of the outstanding balanced of the unearned premium reserve is required in the case of a company that (1) is exempt from tax under section 501(a) by virtue of being described in any paragraph of section 501(c) or is subject to tax only on investment income for its first taxable year beginning after 1986; and (2) was subject to tax as a property and casualty insurance company in a year beginning before 1987. Such companies generally computed taxable income taking into account a reserve for the gross amount of unearned premiums. In such a case, the 20 percent ratable inclusion rule applies for the 6-year period that begins with the first taxable year after 1986 in which the company is subject to tax under section 831(a). Thus, if a company was taxable at some time before 1987, is tax exempt in 1987, and again becomes taxable in a year after 1987, it is appropriate to apply the ratable inclusion rule to the company to provide treatment consistent with other companies that were taxable before 1987.

Treatment of reciprocal insurers.—The bill provides that, in the case of an interinsurer or reciprocal underwriter (within the meaning of sec. 835) that is required under applicable State law to report on its annual statment reserves on unearned premiums net of premium acquisition expenses, the amount of the unearned premiums is to be treated as including an amount equal to such expenses for purposes of the decrease in the deduction for unearned premiums. Absent such a rule, reciprocals and interinsurers would be subject to ratable inclusion of a portion of the unearned premium reserve that did not give rise to mismatching of income and deductions under prior law, which the ratable inclusion rule was intended to address.

4. Treatment of certain dividends and tax-exempt interest (sec. 6670(d) of the bill, sec. 1022 of the Reform Act, and sec. 832(b)(5) of the Code)

Present Law

Present law, as amended by the Reform Act, provides that the deduction of a property and casualty company for losses incurred is reduced by 15 percent of (1) the property and casualty insurance company's tax-exempt interest and (2) the deductible portion of dividends received (with special rules for dividends from affiliates). For purposes of this proration provision, tax-exempt interest includes interest income excludable under section 103 (or deductible under sec. 832(c)(7)), the portion of interest income excludable under section 133, and other similar items. If the amount of this reduction exceeds the amount otherwise deductible as losses incurred, the excess is includible in income.

Explanation of Provision

The bill clarifies the treatment of dividends received for purposes of applying the proration provision in the case of a property and casualty insurance company that files a consolidated return. Under the bill, the determination with respect to any dividend paid by a member to another member of the affiliated group filing the consolidated return is made as if the group were not filing a consolidated return.

The bill also clarifies that the deductible portion of any dividends received from a subsidiary, including those received directly or indirectly from a lower tier subsidiary, are subject to the proration rules in the hands of the property and casualty insurance affiliate. These provisions conform to the application of the proration rules generally to all property and casualty insurance companies.

5. Loss reserves (sec. 6670(e) of the bill, sec. 1023 of the Reform Act, and sec. 846 of the Code)

Present Law

The Reform Act provides for the discounting of the deduction for additions to loss reserves of property and casualty insurance companies to take account partially of the time value of money. The discounting of such deductions is applicable to loss reserves of property and casualty companies, and to loss reserves of life insurance companies that are not required to be discounted under life insurance reserve rules. Special rules are provided in the case of certain accident and health, international, and reinsurance lines of business. The discounting of loss reserves is effective for taxable years beginning after 1986, with a fresh start provision with respect to undiscounted loss reserves applicable to the last taxable year beginning before 1987.

Explanation of Provision

The bill clarifies that, with respect to the special rule for discounting unpaid loss reserves in certain accident and health lines of business (other than unpaid losses relating to disability income), it is assumed that unpaid losses are paid in the middle of the year following the accident year. This assumption is intended to conform to the general assumption for loss reserve discounting purposes that losses are paid in the middle of the year.

The bill provides that the Secretary may prescribe regulations to determine appropriate adjustments in the application of the unpaid loss discounting provisions, in the case of a taxpayer having a taxable year other than the calendar year. Although most property and casualty companies have a calendar taxable year, some companies filing a consolidated return with noninsurance companies will have a fiscal taxable year. The Reform Act did not provide special rules that are used in applying the discounting rules to such fiscal year taxpayers.

The regulations also should provide appropriate adjustments in the application of the discounting provisions in cases in which the Reform Act resulted in a required change in a company's period of accounting (e.g., cases in which the Reform Act results in the application for the first time of sec. 843 , which generally requires property and casualty insurance companies to utilize a calendar taxable year).

The bill also clarifies the application of the fresh start provision in the case of an insurance company that (1) is exempt from tax under section 501(a) by virtue of being described in any paragraph of section 501(c) or, under section 831(b), is taxed only on investment income, in a year beginning after 1986, and (2) later becomes subject to tax under section 831(a) as a regular property and casualty insurance company. The rules relating to the fresh start under the discounting provisions are to be applied by treating the last taxable year before the year in which such a company becomes subject to tax under sec. 831(a) as the company's last taxable year beginning before 1987.

6. Election to be taxed only on investment income (sec. 6670(f) of the bill, sec. 1024 of the Reform Act, and sec. 831(b) of the Code)

Present Law

The Reform Act provided that mutual and stock property and casualty insurance companies with net written premiums or direct written premiums (whichever is greater) in excess of $350,000, but less than $1,200,000, may elect to be taxed only on taxable investment income.

Explanation of Provision

The bill clarifies that the election to be taxed only on investment income, once made and so long as the requirements for the election are met, may be revoked only with the consent of the Secretary. This clarification reflects Congress' intent that the election not be used as a means of eliminating tax liability (e.g., by making the election only for years when the taxpayer does not have net operating losses), but rather as a simplification for small companies.

7. Treatment of Physicians' and Surgeons' Mutual Protection Associations (sec. 6670(g) of the bill and sec. 1031 of the Reform Act)

Present Law

Under the Reform Act, initial contributions to a pooled malpractice insurance association are currently deductible to the extent they do not exceed the cost of a commercial insurance premium for annual converage and are included in the association's income. Refunds of such contributions are deductible to the fund only to the extent included in the income of the recipient. The Reform Act provision applies to associations operating under State law prior to January 1, 1984.

Explanation of Provision

The bill clarifies that initial contributions to a pooled malpractice insurance association under the provision include otherwise qualifying contributions whether paid all in one year or in a series of substantially equal payments over a period that does not exceed 6 years. Members of the association are intended to include provisional members (i.e., those association members who have paid one or more, but not all, of the annual installments of their initial contribution).

8. Special rule for mutual life insurance company (sec. 6670(h) of the bill and sec. 217(i) of the Deficit Reduction Act of 1984)

Present Law

The Deficit Reduction Act of 1984 provided that a mutual life insurance company may elect to treat all individuals noncancellable (or guaranteed renewable) accident and health contracts as through they were cancellable for purposes of determining under section 816 whether or not it is subject to tax as a life insurance company or a property and casualty insurance company. Stock life insurance subsidiaries of electing mutual companies are treated as though they were mutual life insurance companies.

Explanation of Provision

The bill provides that, for purposes of determining the amount of the small life insurance company deduction of a controlled group including an electing mutual company, the taxable income of the electing company is taken into account in applying the phaseout of the small life insurance company deduction, for taxable years beginning after 1986 and before 1992. The bill further provides that the decrease in the amount of Federal revenue by reason of this provision shall not exced $300,000 per taxable year.

9. Annuity diversification requirements (sec. 6670(i) of the bill, sec. 1821(m) of the Reform Act, and sec. 817(h) of the Code)

Present Law

Present law provides that certain variable contracts that are based on a segregated asset account generally are not treated as annuity contracts if the investments made by such account are not (as provided in Treasury regulations) adequately diversified. No special rule is provided for immediate annuities. Treasury regulations were published September 12, 1986, setting forth requirements for adequate diversification of certain variable contracts, including immediate annuities.

Explanation of Provision

The bill provides additional time to comply with the annuity diversification requirement, in the case of variable contracts that are immediate annuities (as defined in sec. 72(u)(4)), that were issued by September 12, 1986, and that do not (as of that date) meet the diversification requirements set forth in the September 12, 1986, regulations because the investments made by the segregated asset accounts under the contracts were invested in Government-guaranteed investments (FDIC- or FSLIC-guaranteed deposits). In such cases, the diversification requirement with respect to Government securities (including Government-guaranteed investments) is waived until December 31, 1988, but applies in full on and after January 1, 1989.

10. Treatment of alternative minimum tax with respect to shareholders surplus account (sec. 6670(j) of the bill and sec. 815(c) of the Code)

Present Law

Present law provides that, in the case of a stock life insurance company having an existing policyholder surplus account, a shareholders surplus account must be continued in order to maintain a record for tax purposes of amounts eligible for distribution before a distribution is made from the policyholders surplus account (and, generally, treated as taxable to the distributing company). In general, the excess of the folowing amounts over the taxes paid for the year are added to the shareholders surplus account: (1) life insurance company taxable income (but not below zero); (2) the small life insurance company deduction; (3) the dividends received deduction allowed; and (4) excluded tax-exempt interest.

Explanation of Provision

The bill provides that, under regulations, in determining additions to the shareholders surplus account, proper adjustments are to be made for any year in which alternative minimum tax is imposed under section 55 of the Code and for all subsequent years. Present law is intended to take account, in calculating the amount in the shareholders surplus account, of net tax liability of the company, and thus should take into account minimum tax and the minimum tax credit.

11. Treatment of certain items as not interest for source rules (sec. 6670(k) of the bill, sec. 1215 of the Reform Act, and sec. 818(f) of the Code)

Present Law

The Reform Act's legislative history indicates that deductions of life insurance companies that are described in Code section 807(c) (1), (2), (3), and (6) should not be treated as interest expenses, under the source rules, for allocation purposes (new Code sec. 864(e), added by section 1215 of the Reform Act). This language could lead to the inference that deduction described in section 807(c) (4) and (5) are interest expenses for allocation purposes.

Explanation of Provision

The bill clarifies that deductions of life insurance companies that are described in Code section 807(c) (which includes paragraphs (1) through (6)) are not to be treated as interest expenses for allocation purposes under new Code section 864(e), added by section 1215 of the Reform Act.

12. Technical corrections to the Deficit Reduction Act of 1984 (secs. 6670 (g) and (i) of the bill, secs. 1821 and 1825(a)(4) of the Reform Act, and secs. 812(e) and 7702 of the Code)

Present Law

Determination of policyholders' share of gross investment income.—Present law provides that the policyholders' share of tax-exempt interest reduces a life insurance company's deduction for certain reserves. For purposes of determining the policyholders' share, sec. 812(e) provides that gross investment income excludes any dividend received by the life insurance company that is a 100-percent dividend. Whether a dividend is a 100-percent dividend is determined by reference to the definition in sec. 805(a)(4)(C), not including dividends described in sec. 805(a)(4)(D). The Reform Act modified the provisions of secs. 805(c)(4) (C) and (D).

Certain policies to cover burial or funeral expenses.—Present law, as amended by the Reform Act, provides that future increases in death benefits may be taken into account in determining whether the definition of a life insurance contract is satisfied with respect to certain policies to cover payment of burial expenses or in connection with prearranged funeral expenses. Such contracts can qualify as life insurance contracts, provided that certain requirements (relating to limitations on increases in the death benefit) are satisfied. The Reform Act provided no special effective date for the provision.

Explanation of Provisions

Determination of policyholders' share of gross investment income.—The bill clarifies that the prior-law definition of 100-percent dividends continues to apply for purposes of determining gross investment income within the meaning of section 812. Thus, the provision is intended to retain the definition as under prior law.

Certain policies to cover burial or funeral expenses.—The bill provides that the rule that future increases in death benefits may be taken into account under the definition of a life insurance contract, with respect to certain policies to cover payment of burial expenses or in connection with prearranged funeral expenses, is effective for contracts entered into on or after October 22, 1986. Congress intended that the provision be prospectively effective.

13. Treatment of certain amounts paid in connection with insurance contracts (sec. 264(a)(4) of the Code)

Present Law

Under present law, the deduction for interest paid or accrued on debt with respect to life insurance policies covering the life of any officer, employee or individual financially interested in any trade or business carried on by the taxpayer is limited. The limitation applies to the extent the aggregate amount of such debt exceeds $50,000 per officer, employee, or financially interested individual.

In the case of a taxpayer carrying on more than one trade or business, the $50,000 amount per officer, employee or person who is financially interested in any trade or business of the taxpayer is determined on an aggregate basis for each such person in all trades or businesses of the taxpayer. For example, if an employee of a business of the taxpayer is also an officer in two other businesses of the taxpayer, the $50,000 of permitted borrowings by the taxpayer with respect to life insurance covering the person is determined by aggregating all policies covering his life subject to this provision and with respect to which the taxpayer has borrowed. In the case of a controlled group of corporations, it is intended that the controlled group is considered to be one taxpayer for this purpose, and all loans with respect to policies covering the life of an officer or employee or person financially interested in a business of any member of the group are aggregated. Similar principles are intended to apply in the event of common ownership of unincorporated trades or businesses.

Reasons for Change

The committee wishes to clarify the application of the $50,000 limitation in the case of employees (or officers or persons financially interested) of a business who are covered by joint and survivor life insurance policies.

Explanation of Provision

In the case of a joint and survivor life insurance policy covering the lives of two or more officers, employees or persons financially interested in the business of the taxpayer, the $50,000 limitation is intended to be applied on a pro rata basis. Thus, for example, if a husband and wife each of whom has an ownership interest in a family business are covered by a joint and survivor life insurance policy, and the business borrows $60,000 under the policy, the borrowed amount is allocated pro rata to each of them. Thus, $30,000 is borrowed with respect to each of them. It is intended that joint and survivor policies so treated be limited to those policies covering related family members, i.e., husband and wife and lineal descendants and ancestors.

14. Nonindividual holders of deferred annuity contracts (sec. 6671(h)(3) of the bill and sec. 72(s) of the Code)

Present Law

Under present law, an annuity contract must provide specific rules for distribution in the event of the contractholder's (owner's) death in order to be treated as an annuity contract for income tax purposes. The Tax Reform Act of 1986 provided special rules to clarify the application of the required distribution rules if the contractholder is not an individual.

Under these special distribution rules, the primary annuitant is treated as the contractholder. Thus, if the primary annuitant dies before the annuity starting date, the entire interest generally is required to be distributed within 5 years after the date of death of the primary annuitant, or is required to be annuitized for some period within one year after the date of death.

Under present law, in order to qualify for favorable income tax treatment, a qualified assignment for purposes of the rules relating to structured settlement agreements is required to provide for periodic payments that are fixed and determinable as to the amount and timing of payment. The qualified assignment could provide for a series of payments over a period that is less than the life of the recipient.

Reasons for Change

The required distribution rules relating to nonindividual holders fail to take account, under present law, of the nature of the promise in the case of a structured settlement agreement. Often, payments made pursuant to a structured settlement agreement will be made over a specified period of time rather than over the life of the recipient. Thus, payments may qualify for the special treatment accorded to structured settlement agreements, but fail to satisfy the required distribution rules for nonindividual holders of annuity contracts.

Explanation of Provision

The bill provides an exception to the required distribution rules for annuity contracts in the case of a qualified assignment (as defined in sec. 130, but without regard to whether there is a qualified funding asset).

Effective Date

The provision would be effective as if included in the Tax Reform Act of 1986.

XI. Pensions and Deferred Compensation; Employee Benefits; ESOPs (Secs. 6671, 6671A, 6671B, 6680(q), and 6687(e) of the Bill)

A. Limitations on Treatment of Tax-Favored Savings

1. Individual retirement arrangements (IRAs) (sec. 6671 (a) and (b) of the bill, secs. 1101 and 1102 of the Reform Act, and secs. 219, 408, 4973, and 6693 of the Code)

a. IRA deduction limit

Present Law

Under present law (sec. 219), a taxpayer is permitted to make deductible IRA contributions up to the lesser of $2,000 or 100 percent of compensation (earned income in the case of a self-employed individual) if:

(1) in the case of a taxpayer who is not married or is married but files a separate return, the taxpayer either (a) has adjusted gross income (AGI) that does not exceed the applicable dollar amount or (b) is not an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the taxable year; or

(2) in the case of married taxpayers filing a joint return, either (a) the couple has AGI that does not exceed the applicable dollar amount or (b) neither spouse is an active participant in an employer-maintained retirement plan for any part of the plan year ending with or within the taxable year.

The applicable dollar amount is (1) $25,000, in the case of an unmarried individual, (2) $40,000, in the case of a married couple filing a joint return, and (3) $0, in the case of a married taxpayer filing separately. The otherwise applicable IRA dollar limit (i.e., $2,000) is reduced by an amount that bears the same ratio to such dollar limit as the taxpayer's AGI in excess of the applicable dollar amount (or, in the case of a married couple filing a joint return, the couple's AGI in excess of the applicable dollar amount) bears to $10,000.

Explanation of Provision

Present law creates an unintended incentive for married couples to file separate returns. If one spouse is an active participant and the other spouse is not, the couple can increase their IRA deduction limit under certain circumstances by filing separate returns.

In order to eliminate this incentive for a married couple living together, the bill provides that, for purposes of determining whether an IRA contribution is deductible for a taxable year, if the couple lives together at any time during the year, the active participant status of both spouses is taken into account for purposes of calculating the IRA deduction limit. If the spouses file separate returns, the applicable dollar amount is $0 and only the AGI of the spouse making the IRA contribution is taken into account.

Also under the bill, a taxpayer is not considered married for a year if the taxpayer and the taxpayer's spouse (1) did not live together at any time during the taxable year, and (2) did not file a joint return for the taxable year. A taxpayer meeting these requirements for a taxable year is treated as an unmarried individual for the taxable year. Accordingly, for purposes of determining the taxpayer's deduction limit, only the taxpayer's AGI and status as an active participant is taken into account, and the applicable dollar amount is $25,000.

b. Nondeductible IRA contributions

Present Law

Under present law, an individual is permitted to make designated nondeductible IRA contributions to the extent that deductible contributions are not allowed due to the AGI phaseout for active participants. In addition, a taxpayer may elect to treat otherwise deductible IRA contributions as nondeductible.

An individual who makes a designated nondeductible contribution to an IRA for a taxable year or who receives a distribution from an IRA during a taxable year is required to provide such information as the Secretary may prescribe on the individual's tax return for the taxable year and, to the extent required by the Secretary, for succeeding taxable years (or on such other form as the Secretary may prescribe). The information that may be required includes, but is not limited to, (1) the amount of designated nondeductible contributions for the taxable year, (2) the amount of distributions from individual retirement plans for the taxable year, (3) the aggregate amount of designated nondeductible contributions for all preceding taxable years which have not previously been withdrawn, and (4) the aggregate balance of all IRAs of the individual as of the close of the calendar year with or within which the taxable year ends. An individual who overstates the amount of designated nondeductible contributions for a year is subject to a penalty of $100 for each overstatement unless it is shown that the overstatement is due to reasonable cause.

Explanation of Provision

Under present law, there is no separate penalty with respect to an individual who fails to file the form prescribed by the Secretary with respect to nondeductible IRA contributions. Accordingly, under the bill, a taxpayer who fails to file the form required by the Secretary is subject to a penalty of $50 for each such failure unless the taxpayer shows that the failure is due to reasonable cause.

In order to take into account taxpayers with fiscal year taxable years, the bill provides that the information that the Secretary may require to be included on the form or return includes the aggregate balance of all IRAs of the individual as of the close of the calendar year in which the taxable year begins (rather than the calendar year with or within which the taxable year ends).

c. IRA withdrawals

Present Law

Present law provides that amounts withdrawn from an IRA during a taxable year are includible in income for the taxable year under rules similar to the rules applicable to qualified plans under section 72. Under special rules applicable to IRAs for purposes of section 72, (1) all IRAs of an individual (including rollover IRAs and simplified employee pensions (SEPs), but excluding deductible qualified voluntary employee contributions) are treated as 1 contract, (2) all distributions that are made during a taxable year are treated as 1 distribution, (3) the value of the contract (calculated after adding back distributions that are made during the year), income on the contract, and investment in the contract are computed as of the close of the calendar year with or within which the taxable year ends, and (4) the aggregate amount of withdrawals excludable from income for all taxable years shall not exceed the taxpayer's investment in the contract for all taxable years.

Explanation of Provision

Under the bill, for purposes of applying the special IRA rules of section 72, the value of the contract (calculated after adding back distributions that are made during the year), income on the contract, and investment in the contract are computed as of the close of the calendar year in which the taxable year begins (rather than the calendar year with or within which the taxable year ends). The provision is intended to facilitate computations with respect to taxpayers with fiscal year taxable years.

d. Excess contributions

Present Law

Distribution prior to due date of return

Under present law (sec. 408(d)(4)), the normal rules for the taxation of distributions (sec. 72) do not apply to a distribution of contributions to an IRA (and, consequently, the contributions are not taxed upon distribution) if (1) the contributions exceed the amount allowable as a deduction under section 219, (2) the distribution is received on or before the due date (including extensions) for the individual's return for the taxable year, (3) no deduction is allowed under section 219 with respect to the excess contributions, and (4) the distribution is accompanied by the amount of net income attributable to the excess contributions. The net income on the contributions is deemed to have been earned and receivable in the taxable year in which the excess contributions were made.

Distribution after due date of return

If the total contributions made to all IRAs for a year (excluding rollover IRAs) does not exceed $2,250, then, under present law, the normal rules for the taxation of distributions (sec. 72) do not apply to a distribution of contributions in excess of the amount allowable as a deduction under section 219 if the excess contributions are distributed after the due date (including extensions) for filing the individual's tax return for the year the contributions were made (sec. 408(d)(5)). For purposes of this rule, the amount allowable as a deduction under section 219 (after application of section 408(o)(2)(B)(ii)) is increased by the nondeductible limit under section 408(o)(2)(B).

Excise tax

Present law provides a 6-percent nondeductible excise tax on contributions to an IRA in excess of the amount allowable as a deduction under section 219 for a taxable year, if the excess contributions are not timely distributed (sec. 4973(b)). For purposes of this rule, the amount allowable as a deduction under section 219 (after application of section 408(o)(2)(B)(ii)) is increased by the nondeductible limit under section 408(o)(2)(B).

Explanation of Provision

Distribution prior to due date of return

The bill amends the rules relating to distributions of excess contributions to take into account the fact that nondeductible contributions may be made to an IRA. The bill permits any IRA contributions to be distributed without income or excise tax consequences prior to the due date (including extensions) for filing the individual's income tax return for the year the contributions are made. Thus, under the bill, the normal rules for the taxation of IRA distributions do not apply to a distribution of any contributions to an IRA if (1) the distribution is received on or before the due date (including extensions) for the individual's return for the taxable year for which the contributions were made, (2) no deduction is allowed under section 219 with respect to the contributions, and (3) the distribution is accompanied by the amount of net income attributable to the contributions. As under present law, net income on the contributions are deemed to have been earned and receivable in the taxable year in which the contributions were made.

Distribution after due date of return

The bill clarifies that certain IRA contributions not in excess of $2,250 may be withdrawn by providing that, for purposes of the rule relating to return of excess contributions after the due date of the individual's return for the year for which the contributions were made, the amount allowable as a deduction under section 219 is computed without regard to the AGI phaseout for active participants (sec. 219(g)).

Excise tax

The bill provides that, for purposes of the excise tax on excess contributions to an IRA, the amount allowable as a deduction under section 219 is computed without regard to the AGI phaseout for active participants (sec. 219(g)).

2. Qualified cash or deferred arrangements (sec. 6671(c) and (1) of the bill, secs. 1105, 1116, and 1879 of the Reform Act, and secs. 401(k), 402, and 4979 of the Code)

a. Limit on elective deferrals

Present Law

In general

Present law provides that the maximum amount that an employee can elect to defer for any taxable year under all cash or deferred arrangements in which the employee participates is limited to $7,000. This $7,000 limit is adjusted for inflation at the same time and in the same manner as the indexing of the dollar limit on benefits under section 415(d). The $7,000 limit applies to the employee's taxable year, regardless of the employer's taxable year or the plan year applicable to the cash or deferred arrangement. The $7,000 limit is coordinated with other plans to which elective deferrals are made.

To ease the administrative burden on employees, employers, and the IRS, the elective deferral arrangements maintained by any single employer may preclude an employee from making elective deferrals under such arrangements for a taxable year in excess of $7,000.

Treatment of excess deferrals

If, for any taxable year, the total amount of elective deferrals contributed on behalf of an employee to all qualified cash or deferred arrangements and other plans subject to the limit exceeds $7,000, then the amounts in excess of $7,000 (the excess deferrals) are included in the employee's gross income for the taxable year to which the deferral relates. In addition, with respect to any excess deferrals, by March 1 after the close of the employee's taxable year, the employee may allocate the excess deferrals among the qualified cash or deferred arrangements and other plans subject to the limit and notify the administrator of each plan of the portion of the excess deferrals allocated to that plan. Not later than April 15 after the close of the employee's taxable year, each plan may (but is not required to) distribute to the employee the amount of the excess deferrals (plus income attributable to the excess deferrals) allocated to the plan.

The distribution may be made without regard to the terms of the plan until the close of the first plan year for which an amendment is required (Act sec. 1140) and notwithstanding any other provision of law. In addition, the Secretary is to prescribe a model plan amendment that permits the distribution of excess deferrals. Distribution pursuant to such amendment is to be treated as in accordance with the plan.

Income on excess deferrals distributed by the applicable April 15 date is treated as earned and received in the taxable year to which the excess deferral relates. Excess deferrals (and earnings thereon) distributed by the applicable April 15 date are not subject to the additional income tax on early withdrawals (sec. 72(t)). Deferrals are not subject to the 10-percent excise tax on nondeductible contributions (sec. 4972) merely because they are excess deferrals.

Reporting requirements

Under the Act, the employer is required to report to an employee and to the IRS the amount of elective deferrals made by the employee and the amount of compensation deferred under section 457 (sec. 6051(a)).

Explanation of Provision

In general

The bill provides that income on excess deferrals is includible in gross income in the year distributed, rather than in the year of the deferral. To prevent individuals from electing to make excess deferrals in order to defer current taxation of income, the bill requires, as a condition of qualification, that a plan that has a cash or deferred arrangement is required to provide that elective deferrals under the arrangement and under all other plans, contracts, or arrangements of the employer maintaining the plan for a calendar year may not exceed the limitation on elective deferrals in effect for taxable years beginning in such calendar year. A similar restriction is required to be included in a simplified employee pension (SEP) (sec. 408(k)), tax-sheltered annuity contract (sec. 403(b)), or section 501(c)(18) plan that permits elective deferrals. The bill provides that, for purposes of the required plan provision, the limit on elective deferrals need not be explicitly set forth, but can be incorporated by reference.

The provision is generally effective with respect to plan years beginning after December 31, 1987. A delayed effective date applies in the case of certain plans maintained pursuant to a collective bargaining agreement with respect to contributions made pursuant to the bargaining agreement.

Treatment of excess deferrals

Under the bill, income on excess deferrals distributed before the applicable April 15 date, including income earned during and after the year to which the deferral relates, is includible in income in the year distributed, rather than in the year to which the deferral relates. The bill clarifies that any distribution of less than the entire amount of excess deferrals plus income attributable to such deferrals is treated as a pro rata distribution of excess deferrals and income.

The bill clarifies that excess deferrals (and income on such deferrals) distributed by the applicable April 15 are not subject to the 15-percent tax on excess distributions (sec. 4980A).

Reporting requirements

The Act did not contain an effective date for the reporting requirement relating to elective deferrals. The reporting requirement was intended to be effective at the same time the Act's limit on elective deferrals was effective. Accordingly, the bill provides that the requirement is effective with respect to calendar years beginning after December 31, 1986.

b. Nondiscrimination requirements

Present Law

Under present law, a special nondiscrimination test applies to limit the elective deferrals that may be made by highly compensated employees. The limit depends (in part) on the level of elective deferrals by nonhighly compensated employees. A cash or deferred ararangement under which only highly compensated employees participate or are eligible to participate does not satisfy the special nondiscrimination test. For purposes of applying the specials nondiscrimination test, under rules prescribed by the Secretary, employer matching contributions that are nonforfeitable and that satisfy certain withdrawal restrictions may be taken into account.

If the special nondiscrimination rules are not satisfied for any year, present law provides that the qualified cash or deferred arrangement will not be disqualified if the excess contributions (plus income allocable to the excess contributions) are distributed before the close of the following plan year. In addition, instead of receiving an actual distribution of excess contributions, an employee may elect to have the excess contributions treated as an amount distributed to the employee and then recontributed by the employee to the plan on an after-tax basis. Such recharacterization is not permitted in the absence of regulations. A plan may provide that an employee is required to make such a recharacterization election as a condition of plan participation.

Distribution of excess contributions may be made notwithstanding any provision of the plan until the first plan year for which plan amendments are required (Act sec. 1140) and notwithstanding any other provision of law. In addition, the Secretary is to prescribe a model plan amendment that permits the distribution of excess contributions. Distribution pursuant to such amendment is to be treated as a distribution made in accordance with the plan. The amount distributed is not subject to the 10-percent additional income tax on early withdrawals (sec. 72(t)). Contributions are not subject to the 10-percent excise tax on nondeductible contributions (sec. 4972) merely because they are excess contributions.

Prior to the Deficit Reduction Act of 1984 (DEFRA), proposed Treasury regulations permitted a cash or deferred arrangement that failed the special nondiscrimination test to be qualified if the arrangement satisfied the general nondiscrimination rules (sec. 401(a)(4)). DERFA provided that a cash or deferred arrangement is not qualified unless it satisfies the special nondiscrimination test, with an exception provide in DEFRA section 527(c)(1)(B). Although the Act modified the nondiscrimination requirements, it did not change the rule enacted in DEFRA section 527(c)(1)(B).

For a discussion of the excise tax on excess contributions and excess aggregate contributions (sec. 4979), see below.

Explanation of Provision

The bill clarifies that, for purposes of the special nondiscrimination test, the elective deferrals of eligible highly compensated employees, rather than all highly compensated employees are taken into account. Under prior law, highly compensated employees were defined by reference to eligible employees. However, the new uniform definition of highly compensated employees does not refer to eligible employees and, therefore, the clarification is necessary to obtain a result consistent with prior law.

The bill provides that, for purposes of determining whether matching contributions may be used to satisfy the special nondiscrimination test for elective deferrals and for purposes of the vesting rules (sec. 411), a matching contribution is not treated as forfeitable merely because the matching contribution is forfeited because the contribution to which it relates is an excess deferral (sec. 402(g)(2)(A)), an excess contribution (sec. 401(k)(8)(B)), or an excess aggregate contribution (sec. 401(m)(6)(B)). The bill clarifies that excess contributions distributed (or treated as distributed) by the end of the plan year following the year the excess contributions arose are not subject to the excise tax on excess distributions (sec. 4980A).

c. Withdrawal restrictions

Present Law

Under present law, withdrawals generally are not permitted under a qualified cash or deferred arrangement prior to death, disability, separation from service, or (except in the case of a pre-ERISA money purchase pension plan or a rural electric cooperative plan) the attainment of age 59½. However, a qualified cash or deferred arrangement (other than a pre-ERISA money purchase pension plan or a rural electric cooperative plan) may permit hardship withdrawals up to the amount of the employee's elective deferrals (but not income on the elective deferrals).

In addition, under the Act, distributions may be made from a qualified cash or deferred arrangement upon (1) termination of the plan without the establishment of a successor plan, (2) the date of sale by a corporation of substantially all of the assets used by the corporation in a trade or business if the employee continues employment with the corporation acquiring the assets, or (3) the date of the sale by a corporation of the corporation's interest in a subsidiary if the employee continues employment with the subsidiary. The Statement of Managers for the Act provided that a distribution upon any of these 3 events is permitted only if the distribution constitutes a total distribution of the employee's balance to the credit in the cash or deferred arrangement.

Explanation of Provision

As originally enacted, the exception to the withdrawal restrictions for certain sales of assets or subsidiaries does not encompass other transactions that have the effect of sales of assets or subsidiaries. The bill expands the exception to include certain dispositions of assets or subsidiaries other than sales and clarifies that the exception only applies if the transferor corporation continues to maintain the plan after the disposition. Thus, the bill provides that distributions can be made from a qualified cash or deferred arrangement on the (1) disposition by a corporation of substantially all of the assets (within the meaning of sec. 409(d)(2)) used by such corporation if the employee continues employment with the transferee corporation and the transferor corporation continues to maintain the plan, or (2) disposition by a corporation of the corporation's interest in a subsidiary (within the meaning of sec. 409(d)(3)) if the employee continues employment with the subsidiary and the transferor corporation continues to maintain the plan.

The bill incorporates statutorily the requirement that a distribution must be a total distribution in order for the exception for dispositions of assets or subsidiaries or termination of a plan to apply. Under the bill, a distribution upon any of these 3 events is permitted only if the distribution is a "lump sum distribution". For this purpose, "lump sum distribution" means a lump-sum distribution under the income averaging rules (sec. 402(e)(4)), but without regard to (1) the required events (such as attainment of age 59½) for eligibility for income averaging, (2) the election requirement, and (3) the minimum period of plan participation requirement. Thus, for this purpose, a distribution can constitute a lump sum distribution even though, for example, the employee receives the distribution prior to age 59½, has already elected lump sum treatment for a prior distribution, or has not been a participant in the plan for at least 5 years.

The bill also provides that the exception to the withdrawal restrictions for the termination of the plan is conditional on the employer not establishing or maintaining another defined contribution plan for a reasonable period established by the Secretary.

d. Other restrictions

Present Law

Under the Act, a cash or deferred arrangement is not qualified if any employer contributions or benefits (other than matching contributions) are conditioned (either directly or indirectly) upon an employee's elective deferrals. The Statement of Managers provides that this prohibition is not limited to benefits provided under a qualified plan, but also applies, for example, to benefits provided under a health plan or under a nonqualified deferred compensation arrangement.

The Act prohibits tax-exempt organizations and State and local governments (or a political subdivision of a State or local government) from establishing qualified cash or deferred arrangements.

The prohibition does not apply to plans adopted before (1) May 6, 1986, in the case of an arrangement maintained by a State or local government (or political subdivision of a State or local government), or (2) July 2, 1986, in the case of an arrangement maintained by a tax-exempt organization. The grandfather treatment is limited to the employers who adopted the plan before the dates specified above. However, the grandfather treatment is not limited to employees (or classes of employees) covered by the plan as of the date the grandfather treatment is provided. Similarly, plans that are grandfathered may be amended in the future. Most such plans will, of course, have to be amended to take into account the new requirements relating to qualified cash or deferred arrangements. Other plan amendments may also be made. For example, a grandfathered plan may be amended in the future to provide for employer matching contributions, to modify the level of employer matching contributions, or to provide that the qualified cash or deferred arrangement is part of a cafeteria plan.

The Act provides that a qualified cash or deferred arrangement can be part of a rural electric cooperative plan, but does not explicitly exempt such plans from the prohibition on maintenance of cash or deferred arrangements by tax-exempt and State and local government employers. The Act defines a rural electric cooperative plan as a defined contribution plan (as defined in sec. 414(i)) that is established and maintained by a rural electric cooperative (as defined in sec. 457(d)(9)(B)) or a national association of such rural electric cooperatives.

Explanation of Provision

The bill reconciles the statutory provision and the intent of Congress articulated in the Statement of Managers by providing that the prohibition on conditioning benefits on elective deferrals is not limited to employer-provided benefits. Thus, for example, a plan may not provide that voluntary after-tax employee contributions may not be made until an employee makes a specified amount of elective deferrals under a qualified cash or deferred arrangement.

The bill modifies the grandfather rule applicable to section 401(k) plans maintained by governmental employers. Under the bill, the prohibition on section 401(k) plans does not apply to (1) an employer that is a State or local government (or political subdivision of a State or local government) if the employer adopted a section 401(k) plan before May 6, 1986, and (2) an employer that is a tax-exempt governmental unit other than a governmental unit described in (1) (e.g., the Tennessee Valley Authority), if the employer adopted a section 401(k) plan before July 2, 1986. Because the grandfather rule in the bill applies to the employer and not merely the plan, an employer that satisfies the conditions of the grandfather may adopt a new section 401(k) plan.

Because the identity of the employer is more likely to change in the case of tax-exempt employers that are not governmental entities (such as through a merger of unrelated tax-exempt organizations), the bill limits this expansion of the grandfather rule to tax-exempt governmental units.

The bill clarifies that the prohibition against cash or deferred arrangements maintained by tax-exempt and State and local government employers does not apply to a rural electric cooperative plan. The bill also modifies the definition of rural electric cooperative. A change in the definition is necessary because the Code section reference in the Act defining a rural electric cooperative was repealed by the Act. Under the bill, a rural electric cooperative is (1) any organization described in section 501(c)(12) which is exempt from tax under section 501(a) and which is engaged primarily in providing electric service on a mutual or cooperative basis, (2) any organization described in paragraph (4) or (6) of section 501(c) which is exempt from tax under section 501(a) and at least 80 percent of the membership of which are organizations described in (1), and (3) an organization which is a national association of organizations described in (1) or (2). The exemption does not apply to a member of an organization described in (3), solely by reason of such membership, if the member is not itself an organization described in (1) or (2). Similarly, the exemption does not apply to a member of an organization described in (2), solely by reason of such membership, if the member is not itself an organization described in (1).

3. Nondiscrimination requirements for employer matching contributions and employee contributions (sec. 6671(m) of the bill, sec. 1117 of the Reform Act, and secs. 401(m) and 4979 of the Code)

a. Special nondiscrimination test

Present Law

In general

Under present law, a special nondiscrimination test is applied to matching contributions and employer contributions, including employee contributions under a qualified cost-of-living arrangement (sec. 415(k)). This special nondiscrimination test is similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements.

The term "matching contributions" means any employee contribution made to the plan on behalf of an employee on account of an employee contribution or an elective deferral under a qualified cash or deferred arrangement. Forfeitures under a plan that are reallocated to participants' accounts on the basis of employee contributions or elective deferrals are, or course, also treated as matching contributions.

Required aggregation

If 2 or more plans of an employer to which matching contributions, employee contributions, or elective deferrals are made are treated as a single plan for purposes of the coverage requirements for qualified plans (sec. 410(b)), then the plans are treated as a single plan for purposes of the special nondiscrimination test. In addition, if a highly compensated employee participates in 2 or more plans of an employer to which matching contributions, employee contributions, or elective deferrals are made, then all such contributions are aggregated for purposes of the special nondiscrimination test.

Explanation of Provision

In general

Under the bill, the special nondiscrimination test applicable to matching contributions and employee contributions only applies to contributions to defined contribution plans within the meaning of sec. 414(k). Also under the bill, the definition of "matching contributions" includes any contribution to a defined contribution plan made on account of an employee contribution or an elective deferral under a qualified cash of deferred arrangement, whether such contributions are made to the same plan or a different plan. Contributions to a defined benefit pension plan may be employee contributions or matching contributions to the extent treated as contributions to a defined contribution plan (sec. 414(k)).

The bill also clarifies, in accordance with the Statement of Managers, that contributions to a tax-sheltered annuity that are made on account of an employee contribution or elective deferral are employer matching contributions. As under the rules applicable to elective deferrals under a cash or deferred arrangement, elective deferrals under a tax-sheltered annuity may be used to help satisfy the nondiscrimination test applicable to matching contributions with respect to a tax-sheltered annuity. (Similarly, consistent with the rules applicable to cash or deferred arrangements, elective deferrals to a tax sheltered annuity may not be used to help a tax-sheltered annuity program satisfy the coverage tests (sec. 410(b)), except for purposes of the average benefits test.)

Under the bill, matching contributions that are treated as elective deferrals for purposes of the special nondiscrimination test applicable to cash or deferred arrangements are not subject to the special test applicable to matching contributions and employee contributions.

Required aggregation

The bill modifies the requirement with respect to aggregation of plans in which a highly compensated employee participates. Under the bill, if a highly compensated employee participates in 2 or more plans of an employer to which contributions subject to the special nondiscrimination test (sec. 401(m)) are made, then all such contributions are aggregated for purposes of the test. For example, assume an employer maintains a plan with a cash or deferred arrangement under which matching contributions are made, and a thrift plan providing for after-tax employee contributions and matching contributions. Highly compensated employees participate in both plans. Under the bill, matching contributions that are not treated as elective deferrals in applying the special section 401(k) nondiscrimination test and after-tax contributions under the plans are aggregated for purposes of the special nondiscrimination test. The elective deferrals, however, are not required to be aggregated with the matching contributions and employee contributions.

b. Treatment of excess aggregate contributions

Present Law

If the special nondiscrimination test is not satisfied for any year, the plan will not be disqualified if the excess aggregate contributions (plus income allocable to such contributions) are distributed before the close of the following plan year. Distribution of excess aggregate contributions by such date may be made notwithstanding any other provision of law, and the amount distributed is not subject to the additional income tax on early withdrawals (sec. 72(t)). Contributions are not subject to the 10-percent tax on nondeductible contributions (sec. 4972) merely because they are excess aggregate contributions.

An excise tax is imposed on the employer with respect to excess contributions and excess aggregate contributions (sec. 4979). The tax is equal to 10 percent of the excess contributions and excess aggregate contributions (but not earnings on those contributions) under the plan for the plan year ending in the taxable year.

However, the tax does not apply to any excess contributions or excess aggregate contributions that, together with income allocable to such contributions, are distributed (or, if nonvested, forfeited) no later than 2½ months after the close of the plan year in which the contributions arose.

Excess matching contributions (plus income), excess elective deferrals (plus income), excess qualified nonelective contributions (plus income), and income on excess employee contributions distributed within the applicable 2½ month period are to be treated as received and earned by the employee in the employee's taxable year to which such contributions relate. Excess matching contributions are deemed to relate to the same taxable year to which the employee's mandatory contribution relates, i.e., mandatory contributions that are elective deferrals relate to the taxable year in which the employee would have received (but for the deferral election) the deferral as cash, and mandatory contributions that are employee contributions relate to the taxable year of contribution. For purposes of this rule, the first contributions (of the type distributed) for a plan year are deemed to be excess contributions or excess aggregate contributions.

Explanation of Provision

The bill provides that excess aggregate contributions for a plan year that are distributed before the end of the following plan year are not subject to the 15-percent excise tax on excess distributions (sec. 4980A).

In addition, to be consistent with the rule applicable to excess deferrals and excess contributions, the bill provides that such distributions may be made without regard to the terms of the plan until the close of the first plan year for which an amendment is required (Act sec. 1140). The bill similarly provides that the Secretary is to prescribe a model amendment that allows a plan to distribute excess aggregate contributions and that a plan distribution in accordance with such amendment is to be treated as in accordance with the terms of the plan. It is understood that the Secretary has already prescribed model amendments under the Act; accordingly, it is not intended that the Secretary be required to prescribe a new amendment regarding excess aggregate contributions.

The Act provides that excess contributions and excess aggregate contributions that are distributed within 2½ months after the end of the plan year are treated as received and earned by the recipient in the taxable year to which the contribution relates in order to prevent deferral of income. Such deferral is not a major concern, however, where the amount involved is not significant. Accordingly, the bill provides an exception to the general rule. Under this exception, if the total distributions of excess contributions and excess aggregate contributions under a plan for a plan year with respect to an individual are less than $100, then the distributions are treated as earned and received by the individual in the taxable year in which the distributions were made.

4. Unfunded deferred compensation arrangements of State and local governments and tax-exempt employers (sec. 6671(e) of the bill, sec. 1107 of the Reform Act, and sec. 457 of the Code)

a. Application to tax-exempt employers; distribution requirements

Present Law

The Act applies the limitations and restrictions applicable to eligible and ineligible unfunded deferred compensation plans of State and local governments (sec. 457) to unfunded deferred compensation plans maintained by nongovernmental tax-exempt organizations.

Under the Act, distributions cannot be made available to participants or beneficiaries under a section 457 plan before the participant is separated from service with the employer or is faced with an unforeseeable emergency. In addition distributions under a section 457 plan are required to comply with the provisions of section 401(a)(9). Under section 401(a)(9) as amended by the Act, distributions are required to begin no later than the April 1 of the calendar year following the calendar year the participant attains age 70½, regardless of whether the participant is still employed. Thus, section 401(a)(9) may require that distribution is to begin before the time that distributions are permitted under section 457.

The Act provides that benefits are not treated as made available under an eligible deferred compensation plan merely because an employee is allowed to elect to receive a lump-sum payment within 60 days of the election. The 60-day rule only applies if the employee's total deferred benefit does not exceed $3,500 and no additional amounts may be deferred with respect to the employee.

Explanation of Provision

The bill reconciles the rules under section 457 and section 401(a)(9) relating to the time that distributions are to be made. With respect to the rule prohibiting distributions prior to separation from service or the occurrence of an unforeseen emergency, the bill provides an exception for distributions in or after the year in which the employee attains age 70½. Thus, under the bill, amounts may not be available under a section 457 plan earlier than (1) the calendar year in which the participant attains age 70½, (2) when the participant separates from service, or (3) when the participant is faced with an unforeseeable emergency.

The bill clarifies that the exception to the constructive receipt rule with respect to an election to receive a lump-sum distribution does not override the distribution restrictions otherwise applicable to eligible deferred compensation plans. Thus, the bill provides that the exception is not available for distributions payable prior to separation from service.

b. Amount of deferrals

Present Law

Under present law, an unfunded deferred compensation plan is not an eligible plan if it permits deferred compensation in excess of the limits contained in section 457. The limit on deferred compensation under a section 457 plan is coordinated with contributions to a tax-sheltered annuity (sec. 403(b)). In addition, under the Act, the limit under section 457 is coordinated with elective deferrals under a cash or deferred arrangement, a simplified employee pension, or a plan described in section 501(c)(18). For example, if an employee participates in a qualified cash or deferred arrangement and an eligible deferred compensation plan, the employee could elect to defer $7,000 under the cash or deferred arrangement and an additional $500 (but no more than $500) under the eligible deferred compensation plan.

Explanation of Provision

An employee may participate in a section 457 plan of 1 employer and, for example, a cash or deferred arrangement of another employer. Thus, the employer maintaining the section 457 plan may not know whether an employee is making elective deferrals to a plan that is coordinated with the section 457 plan for purposes of the limit on deferred compensation. Thus, it is not appropriate to disqualify the entire section 457 plan in such cases.

Accordingly, the bill provides that, for purposes of determining whether an unfunded deferred compensation plan is an eligible plan under section 457, the rule requiring coordination of the deferred compensation limit with other plans is disregarded. Of course, if the limit (as so coordinated) is exceeded, the deferral of income inclusion provided by section 457 does not apply to the excess; instead, the rules of section 457(f) apply to such excess.

In order to prevent avoidance of the limit on deferred compensation under a section 457 plan by, for example, the use of affiliated service groups or leasing arrangements, the bill provides that the Secretary's general regulatory authority to prevent avoidance of certain requirements (sec. 414(o)) applies to section 457 plans.

c. Effective date

Present Law

Under the Act, the requirements of section 457 do not apply to amounts deferred under a plan established by a nongovernmental tax-exempt employer with respect to an employee that (1) were deferred for taxable years beginning before January 1, 1987, or (2) are deferred for taxable years beginning after December 31, 1986, pursuant to an agreement between the employer and the employee that (a) was in writing on August 16, 1986, and (b) on August 16, 1986, provided for a deferral for each taxable year of a fixed amount or an amount determined pursuant to a fixed formula. This exception does not apply with respect to amounts deferred in a fixed amount or under a fixed formula (including a fixed formula under a plan that is in the nature of a defined benefit plan) for any taxable year ending after the date on which the amount or formula is modified after August 16, 1986. The Act was unclear as to whether a plan is required to satisfy the requirements of section 457 (i.e., be an eligible plan) in order to qualify for the grandfather.

Explanation of Provision

The bill clarifies that the grandfather rule applicable to unfunded deferred compensation arrangements of tax-exempt employers applies to all deferred compensation plans of tax-exempt employers that otherwise meet the requirements of the grandfather rule, without regard to whether the plans would be eligible deferred compensation plans within the meaning of section 457.

The bill also clarifies that the grandfather rule only applies to individuals who were covered under the plan and agreement on August 16, 1986. Thus, for example, the grandfather does not apply to a new employee hired after August 16, 1986, or an employee who was hired on or before such date, but who was not a participant in the deferred compensation plan until after August 16, 1986.

5. Deferred annuity contracts (sec. 6671A(i) of the bill, sec. 1135 of the Reform Act, and sec. 72(u) of the Code)

Present Law

Under the Act, if any annuity contract is held by a person who is not a natural person (such as a corporation or trust), then the contract is not treated as an annuity contract for Federal income tax purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year. In the case of a contract the nominal owner of which is a person who is not a natural person, but the beneficial owner of which is a natural person, the contract is treated as held by a natural person.

The provision does not apply to any annuity contract that (1) is acquired by the estate of a decedent by reason of the death of the decedent; (2) is held under a qualified plan (sec. 401(a) or 403(a)), as a tax-sheltered annuity (sec. 403(b)) or under an IRA; (3) is a qualified funding asset for purposes of a structured settlement agreement (as defined in sec. 130(d), but without regard to whether there is a qualified assignment); (4) is purchased by an employer upon the termination of a qualified plan and is held by the employer until the employee separates from service; or (5) is an immediate annuity.

Explanation of Provision

The rule under which certain contracts will not be treated as annuity contracts was intended to apply for purposes of the Federal income taxation of the policyholder, but was not intended to extend to the tax treatment of the insurance company. Accordingly, the bill would clarify that the treatment of annuity contracts held by nonnatural persons applies generally for purposes of subtitle A of Title I of the Code, other than subchapter L.

The bill also provides that, with respect to the exception to the rule regarding treatment of annuity contracts held by nonnatural persons for an annuity that is purchased by an employer upon termination of a qualified plan, the exception applies to an annuity that is held until all amounts are distributed to the employee for whom such contract was purchased or to the employee's beneficiary.

6. Elective contributions under tax-sheltered annuities (sec. 6671(c) of the bill, sec. 1105 of the Reform Act, and sec. 402 of the Code)

a. Catch-up rule

Present Law

The Act imposes a limit on elective deferrals under a tax-sheltered annuity that operates in the same manner as the limit on elective deferrals under a qualified cash or deffered arrangement. However, the annual limit on elective deferrals under a tax-sheltered annuity is $9,500, rather than $7,000.

Thus, the limit on elective deferrals to a tax-sheltered annuity for a year is the least of the following amounts: (1) $9,500, (2) the exclusion allowance under section 403(b), or (3) the limit on annual additions under a defined contribution plan (sec. 415(c)) without regard to the catch-up rules for tax-sheltered annuities (sec. 415(c)(4)).

The $9,500 limit applies until the cost-of-living adjustments to the annual limit on elective deferrals under a qualified cash or deferred arrangement raise that limit from $7,000 to $9,500, at which time the limit on elective deferrals under a tax-sheltered annuity is also indexed at the same time and in the same manner as the indexing of the annual limit for elective deferrals under a qualified cash or deferred arrangement.

The Act provides an exception to the $9,500 annual limit (but not to the otherwise applicable exclusion allowance (sec. 403(b)) or the limit on contributions and benefits (sec. 415)) in the case of employees of an educational organization, a hospital, a home health service agency, a health and welfare service agency, a church, or a convention or association of churches. Under this exception, any eligible employee who had completed 15 years of service with the employer would be permitted to make an additonal salary reduction contribution under the following conditions:

(1) In no year can the additional contributions be more than $3,000 (and, therefore, the $9,500 limit may not be increased above $12,500);

(2) An aggregate limit of $15,000 applies to the total amount of catch-up contributions (i.e., contributions that, in any year, exceed the limit on elective deferrals for that year); and

(3) In no event can this exception be used if an individual's lifetime elective deferrals exceed the individual's lifetime limit.

The lifetime limit on elective deferrals for an individual, solely for purposes of the special catch-up rule, is $5,000 multiplied by the number of years of service that the individual performed with the employer.

This special catch-up rule provides the only rule under which elective deferrals by an individual may exceed the limit on elective deferrals for a year.

It is intended that the definition of years of service for purposes of the special catchup election will include principles similar to the principles of section 414(a). For this purpose, an employee's years of service will be determined by including all years of service with a predecessor employer (within the meaning of sec. 414(a)). Thus, years of service with a denomination of a church that merges into or combines with another denomination generally are to be aggregated with years of service with the surviving denomination.

Explanation of Provision

The Act does not specify how years of service are to be determined for purposes of the catch-up rule. The bill provides that, for this purpose, years of service are defined as in section 403(b). This definition will provide consistency with the way years of service are generally calculated under the rules relating to tax-sheltered annuities.

It is recognized that it may be difficult for employers to calculate whether an individual's lifetime elective deferrals exceed the individual's lifetime limit for purposes of the catch-up rule because employers may not have records for prior years with respect to the portion of contributions to tax-sheltered annuities that were elective deferrals. Accordingly, under the bill, for purposes of calculating an individual's lifetime elective deferrals under the catch-up rule, elective deferrals for prior years are to be determined in the manner prescribed by the Secretary. Under this provision, it is expected that the Secretary will provide administrable methods that employers can use to calculate elective deferrals for prior years.

b. Definition of elective deferrals

Present Law

Unde present law, employer contributions to purchase an annuity contract under a salary reduction agreement (within the meaning of sec. 3121(a)(5)(D)) are considered elective deferrals. The Statement of Managers provides that an employer contribution is not treated as an elective deferral if the contribution is made pursuant to a one-time election to participate in the tax-sheltered annuity even though such contribution would be considered made under a salary reduction agreement under section 3121(a)(5)(D)). This amendment also does not affect the definition of elective deferrals other than with respect to tax-sheltered annuities.

Explanation of Provision

The bill conforms the statutory language to the legislative history by providing that contributions to a tax-sheltered annuity are not considered elective deferrals if the contributions are made pursuant to a one-time irrevocable election made by the employee at the time of initial eligibility to participate in the annuity or are made pursuant to a similar arrangement specified in regulations.

The bill does not change the definition of salary reduction agreement for purposes of section 3121(a)(5)(D).

7. Special rules for simplified employee pensions (sec. 6671(f) of the bill, sec. 1108 of the Reform Act, and secs. 408(k) and 3401 of the Code)

a. Salary reduction SEPs

Present Law

Under the Act, employees who participate in a SEP are permitted to elect to have contributions made to the SEP or to receive the contributions in cash. If an employee elects to have contributions made on the employee's behalf to the SEP, the contributions are not treated as having been distributed or made available to the employee. In addition, the contribution is not treated as an employee contribution merely because the SEP provides the employee with such an election. Therefore, under the Act, an employee is not required to include in income currently the amounts the employee elects to have contributed to the SEP. Elective deferrals under a SEP are to be treated in the same manner as elective deferrals under a qualified cash or deferred arrangement and, thus, are subject to the $7,000 (indexed) cap on elective deferrals.

The Act provides that the tax treatment described above of the election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP. In addition, this exception to the constructive receipt principle is available for a taxable year only if the employer maintaining the SEP had 25 or fewer employees at all times during the prior taxable year.

In addition, under the Act, the amount eligible to be deferred as a percentage of each highly compensated employee's compensation (i.e., the deferral percentage) is limited by the average deferral percentage (based solely on elective deferrals) for all nonhighly compensated employees who are eligible to participate. The deferral percentage for each highly compensated employee cannot exceed 125 percent of the average deferral percentage for all eligible nonhighly compensated employees.

If the 125-percent test is not satisfied, rules similar to the rules applicable to excess contributions to a cash or deferred arrangement are to apply.

Explanation of Provision

The bill clarifies that, for purposes of the rules relating to SEPs (other than sec. 408(k)(2)(C)), the uniform definition of compensation (sec. 414(s)) applies. The bill also clarifies that, for purposes of applying the 125 percent test to a salary reduction SEP, compensation does not include compensation in excess of $200,000.

The bill clarifies that, in determining whether the employer maintaining a salary reduction SEP had more than 25 employees in the prior taxable year, only employees who were eligible to participate in the SEP (or would have been required to be eligible to participate if a SEP were maintained) are taken into account. This rule is consist with the eligibility rules for SEPs, that is, individuals who are not required to be eligible to participate in the SEP may be disregarded in determining whether the 25-employee rule is satisfied.

The bill adds provisions designed to ensure that excess contributions to a salary reduction SEP are distributed. These rules are different from the rules relating to excess deferrals in cash or deferred arrangements because, in the case of a SEP, the employer may not force an employee to take a distribution of excess deferrals because the SEP contributions are held in an IRA which the employee controls.

The bill specifically authorizes the Secretary to prescribe appropriate rules, including rules requiring that the excess contributions (plus income) be distributed, reporting requirements, and rules providing that contributions to a SEP (plus income) may not be withdrawn until a determination that the special nondiscrimination test has been satisfied is made. In addition, the bill provides that, until such a determination has been made, any transfer or distribution from a SEP of salary reduction contributions (or income on such contributions) is subject to tax in accordance with section 72 and to the early withdrawal tax (sec. 72(t)(1)), regardless of whether an exception to the tax would otherwise be available.

b. Integration rules

Present Law

The Act eliminated the prior-law rules under which nonelective SEP contributions could be combined with employer OASDI contributions for purposes of the applicable nondiscrimination requirements. In place of these rules, the Act permits nonelective SEP contributions to be tested for nondiscrimination under the new rules for qualified defined contribution plans permitting a limited disparity between the contribution percentages applicable to compensation below and compensation above the integration level. This provision is effective for years beginning after December 31, 1986. The new rules for defined contribution plans permitting a limited disparity between contribution levels are generally applicable to qualified plans for years beginning after December 31, 1988.

Explanation of Provision

The bill coordinates the effective date of the new integration rules with respect to qualified plans and SEPs. Thus, the bill provides that the integration rules applicable to SEPs (sec. 408(k)(3)(D) and (E)) prior to the Act will continue to apply to years beginning before January 1, 1989, when the new integration rules are effective. However, no integration is permitted under the 125-percent nondiscrimination test for salary reduction SEPs.

c. Income exclusion

Present Law

Under present law, contributions to SEPs are excludable from income, rather than allowable as a deduction as under prior law.

Explanation of Provision

To conform to the conversion of the SEP deduction to an exclusion, the bill provides that, for purposes of section 408(d) (4), (5) and section 4973, an amount excludable from income under section 402(h) is treated as an amount allowable as a deduction under section 219. In addition, the bill amends the definition of wages for withholding tax purposes (sec. 3401(a)(12)(C)) to provide that contributions to a SEP are not considered wages if it is reasonable to believe that the contributions will be excludable from income (rather than deductible).

d. Employer deduction

Present Law

Employer contributions to a SEP are deductible (1) in the case of a calendar year SEP, for the taxable year with or within which the calendar year ends, and (2) in the case of a SEP maintained on the basis of the taxable year of the employer, for such taxable year. The amount deductible in a taxable year for contributions to a SEP may not exceed 15 percent of the compensation paid to the employees during the calendar year ending with or within the taxable year.

Explanation of Provision

To take into account SEPs that are maintained on the basis of the employer's taxable year, the bill provides that, in the case of such SEPs, the 15 percent of compensation limitation applies to compensation paid during the employer's taxable year.

B. Nondiscrimination Requirements

1. Minimum coverage requirements (sec. 6671(h) of the bill, sec. 1112 of the Reform Act, and sec. 410(b) of the Code)

a. Coverage requirements—general

Present Law

Under the present law, a plan is not qualified unless it meets at least one of the following coverage requirements:

(1) the plan benefits at least 70 percent of all nonhighly compensated employees;

(2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or

(3) the plan meets the average benefits test, one requirement of which is that the average benefit percentage for nonhighly compensated employees be at least 70 percent of the average benefit percentage for highly compensated employees.

Under present law, these coverage rules are to apply separately to former employees under rules prescribed by the Secretary.

Explanation of Provision

The bill incorporates in the statute the provision in the Statement of Managers that a plan maintained by an employer that has no nonhighly compensated employees for a year is considered to satisfy the coverage requirements for such year. As is so with respect to the coverage rules generally, this rule is to apply separately with respect to former employees under rules prescribed by the Secretary.

In addition, the committee intends that the Secretary is to exercise his authority with respect to the application of the coverage rules to former employees to except, in appropriate cases, retiree benefit increases from the general rule of separate testing.

b. Coverage requirements for collectively bargained plans

Present Law

Under present law, certain special rules apply to a plan maintained pursuant to an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and 1 or more employers. Under these special rules, the coverage rules (sec. 410 (other than section 410(a))) are to be applied as if all employees of each of the employers who are parties to the collective bargaining agreement and who are subject to the same benefit computation formula under the plan were employed by a single employer (sec. 413(b)(1)). In addition, certain other rules (secs. 401(a)(4) and 411(d)(3)) are to be applied as if all participants who are subject to the same benefit computation formula and who are employed by employers who are parties to the collective bargaining agreement were employed by a single employer (sec. 413(b)(2)).

Explanation of Provision

Under the bill, the special rules of section 413(b)(1) (with respect to the coverage rules) and (b)(2) do not apply to a plan that covers any professional employee (e.g., doctor, lawyer, or investment banker). Thus, such plans are to apply sections 401(a)(4), 410 (without regard to section 410(a)) and 411(d)(3) under the general rules otherwise applicable with respect to qualified plans.

c. Definition of elective deferrals

Present Law

Under present law, certain special coverage rules apply to employer contributions to purchase a tax-sheltered annuity contract (sec. 403(b)) under a salary reduction agreement (within the meaning of sec. 3121(a)(5)(D)). The Statement of Managers provides that an employer contribution is not subject to these special coverage rules (and is instead subject to the general coverage and nondiscrimination rules applicable to qualified plans) if the contribution is made pursuant to a one-time election to participate in the tax-sheltered annuity, even though such contribution would be considered made under a salary reduction agreement under section 3121(a)(5)(D).

Explanation of Provision

The bill conforms the statutory language to the legislative history by providing that contributions to a tax-sheltered annuity are not subject to the special coverage rules (and are instead subject to the general coverage and nondiscrimination rules applicable to qualified plans) if the contributions are made pursuant to a one-time irrevocable election made by the employee at the time of initial eligibility to participate in the annuity or are made pursuant to a similar arrangement specified in regulations.

The bill does not change the definition of salary reduction agreement for purposes of section 3121(a)(5)(D). This amendment also does not affect the definition of elective deferrals other than with respect to tax-sheltered annuities.

2. Minimum participation rule (sec. 6671(h) of the bill, sec. 1112 of the Reform Act, and sec. 401(a)(26) of the Code)

Present Law

In general

Under present law, a plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer, or (b) 40 percent of all employees of the employer. This requirement may not be satisfied by aggregating comparable plans. Also, this requirement applies on an employer-wide basis and may not be satisfied on a line of business or operating unit basis.

Sanction

If a plan ceases to be qualified because of this minimum participation rule, it is subject to the generally applicable sanctions, one of which is that employer contributions made to the trust during the corresponding taxable year of the employer are includible in employees' incomes under rules applicable to nonqualified arrangements (sec. 83). Under present law, in the case of a plan that fails to be qualified solely because it does not satisfy the coverage requirements (sec. 410(b)), the employee's vested accrued benefit (other than employee contributions), to the extent that such amount has not been previously taxed to the employee, is includible in income, rather than the employer's contribution for the year. Also, nonhighly compensated employees are not taxable on amounts contributed to or earned by the trust merely because a plan fails to satisfy the coverage requirements.

Reversion transition rule

For purposes of the coverage rules, but not the minimum participation rule, a special transition rule applies in the case of certain dispositions or acquisitions of a business (sec. 410(b)(6)(C)).

Reversion tax and interest rate

The minimum participation rule is generally effective for plan years beginning after December 31, 1988.

Under a special rule, if (1) a plan is in existence on August 16, 1986, (2) the plan would fail to meet the requirements of the minimum participation rule if such rule were in effect on August 16, 1986, and (3) there is no transfer of assets to or liabilities from the plan, or merger or spinoff involving the plan, after August 16, 1986, that has the effect of increasing the amount of assets available for an employer reversion, such plan may be terminated or merged prior to the first plan year to which the minimum participation rule applies and the 10-percent excise tax on the reversion of assets (sec. 4980) will not be imposed on any employer reversion from such plan by reason of such termination or merger. Such a termination and reversion are permissible even though the terminating plan relies on another plan that is not terminated for qualification. In determining the amount of any such employer reversion, the present value of the accrued benefit of any highly compensated employee is to be determined by using an interest rate that is equal to the maximum interest rate that may be used for purposes of calculating a participant's accrued benefit under section 411(a)(11)(B). The Secretary is to prescribe rules preventing avoidance of this interest rate rule through distributions prior to or in lieu of a reversion.

Explanation of Provision

Line of business

Under the bill, the Secretary may permit, under appropriate circumstances, the minimum participation rule to be applied separately to separate lines of business, as defined under section 414(r) without regard to section 414(r)(7). Thus, for this purpose, separate operating units are not considered to be separate lines of business.

In determining whether to permit this separate testing, the Secretary is to consider whether the separate lines of business are related. For example, a football team and a manufacturing business are totally unrelated, so that it may be appropriate to allow separate testing in such circumstances.

Sanction

The bill modifies the sanction applicable to a plan that ceases to be qualified based on a failure to satisfy either the minimum participation rule or the coverage rules. Under the bill, if a plan is not qualified and one of the reasons is the failure to satisfy the minimum participation rule or the coverage rules, any highly compensated employee is to include in income such employee's vested accrued benefit (other than such employee's investment in the contract). (This modification does not affect the application of the general rules of sec. 402(b)(1) regarding issues other than the amount includible in the year of disqualification, such as the application of sec. 72 to distributions from the disqualified plan.)

In addition, if a plan is not qualified solely because it does not satisfy either the minimum participation rule or the coverage rule or both, the bill provides that there is to be no inclusion in income by reason of such failure to qualify with respect to any employee who was not a highly compensated employee at any time during the trust year in which the plan became disqualified or during any prior year for which service was creditable to such employee under the plan (or a predecessor plan). For purposes of determining whether an employee was a highly compensated employee in any year, the definition of highly compensated employee applicable with respect to such year for purposes of the coverage rules is to apply.

Except for these changes, the sanctions applicable under present law, including the rules regarding the disallowance of an employer's deduction for contributions to a disqualified plan, continue to apply.

These modifications of the sanctions for disqualification are intended to fulfill the intent of the Act with respect to (1) ensuring that the disqualification sanction is adequate with respect to highly compensated employees, and (2) reducing the sanction with respect to nonhighly compensated employees in appropriate circumstances.

Applicability of affiliated service group and employee leasing rules

In order to prevent avoidance of the minimum participation rule, the bill provides that the affiliated service group rules (sec. 414(m)) and the employee leasing rules (sec. 414(n)) apply for purposes of the minimum participation rule. The bill further clarifies that the Secretary's general regulatory authority to prevent avoidance of certain requirements (sec. 414(o)) applies to the minimum participation rule.

Special transition rule

Under the bill, the special transition rule applicable in the case of certain dispositions or acquisitions of a business (sec. 410(b)(6)(C)) is to apply to the minimum participation rule. This is intended to prevent the minimum participation rule from disrupting business transactions by allowing a grace period following certain transactions for the new entities to comply with the minimum participation rule.

Reversion tax and interest rate

With respect to the rule under present law regarding the exemption from the reversion tax in the case of the termination or merger of certain plans not satisfying the minimum participation rule, the interest rate required to be used in determining the accrued benefit of any highly compensated employee and the corresponding reversion to the employer will in many cases understate the value of the employee's accrued benefit and thus represent an inappropriate reduction in the employee's accrued benefit. In order to avoid this result, the bill modifies the rule referred to above in several respects.

First, the bill clarifies that for purposes of determining the amount to be distributed from a plan to an employee, the value of an employee's accrued benefit is not to be affected by this transitional rule regarding the minimum participation rule. Thus, for this purpose, the accrued benefit is to be determined under the interest rate used by the plan, if otherwise permissible under the Code.

Second, the bill provides a rule regarding the permissible interest rate to be used for certain purposes. The interest rate rule applies in the case of a termination, asset transfer, or asset distribution with respect to a plan that would have failed to satisfy the requirements of the minimum participation rule had the effective date of such rule been August 16, 1986.

If the interest rate rule applies to a plan, the interest rate used in determining an "eligible amount" is to be no less than the highest of:

(1) the rate in effect under the plan on August 16, 1986, or if on August 16, 1986, the rate is determined under a formula (or other method), the rate determined under such formula (or other method):

(2) the highest rate applicable under the plan at any time after August 15, 1986, and before the termination, transfer, or distribution in calculating the present value of the accrued benefit of a nonhighly compensated employee under the plan (or any other plan used in determining whether the plan meets the requirements of sec. 401). For this purpose, if at any time during this period the rate is determined under a formula (or other method), the rate considered to be used during any such period is the rate that would be determined under the formula (or other method) if such formula (or other method) were in effect on the date of termination, transfer, or distribution; or

(3) 5 percent.

For purposes of (1) and (2) above, the rate is to be determined without regard to any amendment adopted after August 16, 1986, even if such amendment is effective retroactively to apply on August 16, 1986. If more than one rate (or formula or method) applies under a plan, such as different rates applying to benefits of different value, the rate applicable under the plan for purposes of (1) and (2) above is the highest of the different rates.

The term "eligible amount" means the amount that with respect to a highly compensated employee:

(1) may be rolled over under the applicable rules (sec. 402(a)(5));

(2) is eligible for income averaging (sec. 402(e)(1)) or grandfathered capital gains treatment; or

(3) may be transferred to another plan without inclusion in income.

In addition, if an annuity contract purchased after August 16, 1986, is distributed to a highly compensated employee by a plan to which the interest rate rule applies in connection with a termination of or distribution from such plan, the annuity contract is included in the employee's income to the extent of the excess of the purchase price of such contract over the present value of such contract using the lowest interest rate permitted in determining an eligible amount under the rules described above. However, such excess is to be disregarded for purposes of the early withdrawal tax (sec. 72(t)) and the excess distribution tax (sec. 4980A).

In the case of a termination of or distribution from a plan to which the interest rate rule applies, the excess (if any) of (1) the amount distributed to a highly compensated employee by reason of the termination or distribution over (2) the amount determined by using the lowest interest rate permitted in determining an eligible amount, also is disregarded for purposes of the early withdrawal tax and the excess distribution tax.

Former employees

The committee further intends that for purposes of the minimum participation rule, former employees generally are to be tested separately under rules similar to those applicable for purposes of the coverage rules.

3. Vesting standards (sec. 6671(i) of the bill and sec. 1113 of the Reform Act)

Present Law

Under present law, a plan (other than a multiemployer plan) is not qualified unless a participant's employer-provided benefit vests at least as rapidly as under 1 of 2 alternative schedules. A plan satisfies the first schedule if a participant has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service.

In the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions is required to be 100-percent vested no later than upon the participant's completion of 10 years of service. This exception applies only to employees covered by the plan pursuant to a collective bargaining agreement.

Prior to the Act, special vesting rules applied to class-year plans. A class-year plan was a profit-sharing, money purchase, or stock bonus plan that provided for the separate vesting of employee rights to employer contributions on a year-by-year basis. The minimum vesting requirements were satisfied under prior law if the plan provided that a participant's rights to amounts derived from employer contributions with respect to any plan year were nonforfeitable not later than the close of the fifth plan year following the plan year for which the contribution was made.

The imposition of the new vesting rules described above, including the repeal of class-year vesting, generally apply to plan years beginning after December 31, 1988, with respect to participants who have at least 1 hour of service after the effective date.

Explanation of Provision

The repeal of class-year vesting was not intended to adversely affect the vesting status of any participant. To fulfill this intent, the bill provides a special rule applicable to plans that after October 22, 1986, used class-year vesting. Whether a plan falls within this category is to be determined without regard to any amendment adopted after October 22, 1986, eliminating class-year vesting.

Plans the fall within the above category are to apply a special rule to any employee that has an hour of service (1) before the adoption of any amendment eliminating class-year vesting, and (2) on or after the first day of the first plan year for which the repeal of class-year vesting is applicable to such employee with respect to the plan. Under this special rule, for the year described in (2) above and any subsequent year, the employee's nonforfeitable right to the employee's accrued benefit derived from employer contributions is to be determined under the class-year vesting schedule that was eliminated if such schedule would yield a larger nonforfeitable right than the new vesting schedule.

4. Application of nondiscrimination rules to integrated plans (sec. 6671(g) of the bill, sec. 1111 of the Reform Act, and secs. 401 (a)(5) and (l) of the Code)

Present Law

Under present law, a plan is not considered discriminatory merely because contributions or benefits of, or on behalf of, the employees under the plan favor highly compensated employees through permissible integration of the plan. In general, in the case of a defined contribution plan, whether integration is permissible is determined by comparing contributions with respect to compensation above the integration level with contributions with respect to compensation up to the integration level. In the case of a defined benefit excess plan, the rules apply to benefits, rather than contributions, with respect to compensation above and below the integration level.

In the case of a defined benefit excess plan, certain special tests apply if the integration level is above covered compensation. For this purpose, the term "covered compensation" means, with respect to an employee, the average of the taxable wage bases in effect for each year during the 35-year period ending with the year the employee attains age 65, assuming no increase in such wage base for years after the current year and before the employee actually attains age 65.

An integrated defined benefit plan is required to base benefits on average annual compensation.

Explanation of Provision

The bill clarifies that generally it is only employer-provided contributions and benefits that are taken into account in determining whether the contributions or benefits with respect to compensation above and below the integration level satisfy the integration rules.

To fulfill Congressional intent to conform certain qualified plan rules to the social security system, the bill modifies the definition of "covered compensation," so that the references to age 65 are replaced by social security retirement age (sec. 415(b)(8)), which can be between age 65 and age 67, depending on the date of birth of the employee.

The bill also clarifies that "average annual compensation" means the participant's highest average annual compensation for any period of at least 3 consecutive years (or, if shorter, the participant's full period of service). Thus, defined benefit plans providing benefits based on career average compensation are not prevented from integrating.

5. Definitions of highly compensated employee and of line of business (sec. 6671 (j) and (k) of the bill, secs. 1114 and 1115 of the Reform Act, and sec. 414 (q) and (r) of the Code)

Present Law

Highly compensated employee

In general

In general, under present law, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined in sec. 416(i)); (2) received more than $75,000 in annual compensation from the employer; (3) received more than $50,000 in annual compensation from the employer and was a member of the top-paid group (generally, the top 20 percent by compensation) during the same year, or (4) was an officer of the employer (generally, as defined in sec. 416(i)). For purposes of this definition, the term "compensation" means compensation as defined under section 415(c)(3) plus certain elective contributions.

Treatment of family members

Present law provides a special rule for the treatment of family members of certain highly compensated employees. Under the special rule, if an employee is a family member of either a 5-percent owner or 1 of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any contributions or benefits under the plan on behalf of such family member are aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee.

An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

Even if a family member is excluded for purposes of determining the number of employees in the top-paid group (as discussed below), such family member is subject to the aggregation rule.

Top-paid group

The top-paid group of employees includes all employees who are in the top 20 percent of the employer's workforce on the basis of compensation paid during the year. For purposes of determining the size of the top-paid group (but not for identifying the particular employees in the top-paid group), the following employees are to be excluded: (1) employees who have not completed 6 months of service; (2) employees who normally work less than 17½ hours per week: (3) employees who normally work not more than 6 months during any year; (4) except to the extent provided in regulations, employees who are included in a unit of employees covered by a collective bargaining agreement; (5) employees who have not attained age 21; and (6) employees who are nonresident aliens and who receive no United States-source earned income. An example of an instance in which it is appropriate to consider employees covered by a collective bargaining agreement is the case in which the plan being tested is maintained pursuant to a collective bargaining agreement.

For purposes of this special rule, an employer may elect to apply numbers (1), (2), (3), and (5) above by substituting any shorter period of service or lower age than is specified in (1), (2), (3), or (5), as long as the employer applies the test uniformly for purposes of determing its top-paid group with respect to all its qualified plans and employee benefit plans and for purposes of the line of business or operating unit rules described below.

Officers

For purposes of the definition of highly compensated employee, no more than 50 employees (or, if lesser, the greater of 3 employees or 10 percent of the employees) are to be treated as officers. This same limitation applies for purposes of determining key employees under section 416(i).

Line of business or operating unit rules

Generally, if an employer is treated as operating separate lines of business or operating units for a year, the employer may apply the new coverage rules applicable to qualified plans and the new nondiscrimination rules applicable to statutory employee benefit plans separately to each separate line of business or operating unit for that year.

Under a special rule, a line of business or operating unit will not be treated as separate unless it satisfies certain requirements, one of which is that the line of business or operating unit have at least 50 employees.

In addition, an affiliated service group (within the meaning of sec. 414(m)) may not be treated as consisting of separate lines of business or operating units. Because generally section 414 (b) and (c) applies before section 414(m), a group that is treated as aggregated under section 414 (b) and (c) is not treated as an affiliated service group even if such group also could have been aggregated under section 414(m).

Explanation of Provision

Highly compensated employees

Indexing

The bill provides that the $50,000 and $75,000 amounts are to be adjusted at the same time and in the same manner as the dollar limit applicable to defined benefit plans (sec. 415(d)). Such adjustments will prevent the definition of "highly compensated employee" from becoming inappropriate by virture of inflation.

Nonresident aliens

In addition, under the bill, nonresident aliens who receive no United States-source earned income from the employer are to be disregarded for all purposes in determing the identity of the highly compensated employees of the employer. This modification will simpify the application of the rules and will prevent employees who are disregarded for purposes of the nondiscrimination rules from affecting the identity of the highly compensated employees.

Treatment of family members

The bill clarifies the applicability of the special rule for family members of certain highly compensated employees. The rule generally is to be used in applying any provision that refers to the definition of highly compensated employee (e.g., secs. 89, 401(a)(4), 401(a)(5), 401(k), 401(l) (through sec. 401(a)(5)), 401(m), 403(b)(12) (by reference to 401(a)(4), etc.), 408(k), 410(b). Thus, the special rule does not apply for purposes of, for example, the limits on contributions or benefits (sec. 415) or the $7,000 limit on elective deferrals (sec. 402(g)).

In addition, the bill provides the Secretary with regulatory authority to prevent the application of the special family member rule to inappropriate, clearly unintended situations. This regulatory authority is only to be used, however, in a manner consistent with the general policy underlying the family memer rule, i.e., that, for purposes of all rules relating to nondiscrimination (or deductibility), the members of the family constitute one economic unit and thus are to be treated as one employee.

For example, assume employees A and B are married and both work for the same employer. A's compensation is $150,000 for the 1990 plan year; and she is one of the top 10 highly compensated employees (by compensation). B's compensation is $25,000. Assume further that the employer maintains a money purchase pension plan providing contributions of 10 percent of compensation. The Secretary's regulatory authority could be exercised to prevent the plan from allocating any more than $15,000 to A's account for the 1990 plan year. Thus, the Secretary could preclude the use of compensation paid to one person to be used to provide allocations or accruals to another person.

The bill also clarifies that the special family member rule applies for purposes of the $200,000 limit on the amount of compensation that may be taken into account under a qualified plan (for qualification or deduction purposes) or under an employee benefit plan (secs. 89, 401(a)(17), and 404(1)). (The special family member rule does not apply, however, for purposes of the $200,000 limit that applies under section 416(d), but which was repealed generally for years beginning after December 31, 1988.) However, for this purpose, the definition of a family member is modified to refer only to the employee's spouse and lineal descendants of the employee who do not attain age 19 by the close of the year.

For example, assume that employee A of employer X receives compensation (as defined under sec. 414(s)) of $275,000 and is the highly compensated employee with the highest compensation from X. A's spouse (B), adult child (C), and 17-year old child (D) also are employees of X. B, C, and D receive $100,000, $225,000, and $10,000 of compensation (as defined under sec. 414(s)), respectively. X maintains a qualified cash or deferred arrangement (sec. 401(k)) under which A, B, C, and D are eligible. A, B, and C each defers $7,000 under the arrangement; D makes no deferral.

For purposes of applying the special nondiscrimination test applicable to the arrangement (sec. 401(k)(3)), A, B, C, and D are treated as 1 employee. The compensation of this "1 aggregated employee" is determined as follows: A, B, and D are combined and limited to $200,000 (rather than the $385,000 they actually receive). The $200,000 limit applies separately to C because, under the special definition of a family member for purposes of the $200,000 limit, C is not a family member of A, B, or D. Thus, the compensation taken into account for the aggregated employee is $200,000 (for A, B, and D) plus $200,000 (for C) for a total of $400,000. The total deferrals for this aggregated employee are $21,000. Thus, for purposes of applying the special nondiscrimination test to the cash or deferred arrangement, A, B, C, and D are treated as a single employee with a deferral percentage of $21,000/$400,000 or 5.25 percent. Since the family aggregation rule does not apply for purposes of the $7,000 limit on elective deferrals (sec. 402(g)), none of the family members is considered to have exceeded such limit.

The bill further clarifies the application of the special family member rule to the integration rules under section 401(l). Although the special family member rule generally applies for purposes of section 401(l), it does not apply in determining the amount of compensation below the plan's integration level except that the total of the compensation below the integration level is subject to the $200,000 limit (sec. 401(a)(17)). Thus, for example, assume the same facts described in the above example, except that instead of maintaining a qualified cash or deferred arrangement, X maintains an integreated, nonelective profit-sharing plan with an integration level of $43,800. Again, the compensation of the aggregated employee is $400,000. Of that $400,000, a total of $141,400 is considered to be below the integration level (i.e., $43,800 each attributable to A, B, and C, and $10,000 attributable to D).

Compensation

Although the definition of compensation used for purposes of determining highly compensated employees under section 414(q) generally is based on the definition used under section 415(c)(3), the committee intends that the definitions vary in certain ways. First, the committee does not intend to require that, for purpose of section 414(q), compensation be determined on the basis of the plan's limitation year under section 415. Second, it is not intended that employers be permitted to use an employee's accrued compensation for purposes of section 414(q).

Officers

The employees who are excluded for purposes of determining the size of the top-paid group are to be excluded for purposes of determining the 10-percent limit on the number of officers. (As with respect to the top-paid group, the excluded employees may be officers; they are only excluded for purposes of determining the limit on the number of officers.) This limit is to apply for purposes of determining highly compensated employees and key employees (sec. 416).

Line of business or operating unit rules

Under the bill, the Secretary is to prescribe rules providing certain minimum standards regarding the age and service requirements that are to apply for purposes of determining which employees are taken into account in determining if a line of business or operating unit may be treated as separate. (The standards are to apply, for example, for purposes of determining if a line of business or operating unit has 50 employees.) Under this authority, the Secretary could provide that, for such purpose, section 414(q)(8) is to be applied without regard to the last sentence thereof, i.e., the employer may not elect to reduce the age or service requirements specified in the statute.

The primary purpose for this provision of the bill is to prevent the use of nominal age or service requirements to avoid the effect of the requirement that, to be treated as separate, a line of business or operating unit is required to have 50 employees.

6. Definition of compensation (sec. 6671(k) of the bill, sec. 1115 of the Reform Act, and sec. 414(s) of the Code)

Present Law

Under present law, except as otherwise provided, "compensation" is defined as compensation for services for an employer that is includible in gross income (sec. 414(s)). The Secretary is to prescibe regulations defining compensation for a self-employed individual based on this definition applicable to common-law employees.

The employer may elect whether to include elective deferrals (under secs. 125, 402(a)(8), 402(h), or 403(b)) as part of compensation. In addition, the Secretary is directed to provide certain alternative definitions of compensation that do not favor highly compensated employees.

An employee who at any time during the plan year or any of the 4 preceding plan years is a 1-percent owner of the employer and has annual compensation from the employer of more than $150,000 is a key employee.

Explanation of Provision

The bill modifies the general definition of compensation so that generally it is the same one used (for employees or self-employed individuals, whichever is applicable) for purposes of the limit on contributions under a defined contribution plan (sec. 415(c)(3)). (The bill does not affect the employer's right to elect to include elective deferrals or the Secretary's authorization to provide alternative definitions of compensation.) This provides greater uniformity, and excludes certain items (such as deductible reimbursements of moving expenses) that were not intended to be taken into account. It is not the intent of the bill, however, to restrict future regulatory modifications of the definition of compensation under section 415(c)(3).

Although the general definition of compensation under section 414(s) is to be the same one used under section 415(c)(3), the committee intends that the definitions vary in certain ways. First, the committee does not intend to require that, for purposes of section

414(s), the general definition of compensation be determined on the basis of the plan's limitation year under section 415. Second, it is not intended that the general definition of compensation under section 414(s) be an employee's accrued compensation. Third, the general definition of compensation for purposes of section 414(s) is not to include amounts received while an employee is not a participant.

The bill also clarifies that the definition of compensation provided in section 414(s) only applies to provisions that specifically refer to it. Thus, for example, the definition does not apply for purposes of the limits on deductions (sec. 404) or on contributions and benefits (sec. 415).

Under the bill, for purposes of determining whether an employee is a key employee by virtue of having annual compensation over $150,000, compensation means compensation as defined in section 415(c)(3) plus elective deferrals under sections 125, 402(a)(8), 402(h), and 403(b). This is the same definition used for purposes of determining whether an employee is highly compensated (sec. 414(q)(7)), a determination that is similar to the determination of who is a key employee. This provision of the bill applies to years beginning after December 31, 1988.

C. Treatment of Distributions

1. Uniform minimum distribution rules (sec. 6671A(a) of the bill, sec. 1121 of the Reform Act, and secs. 402(a)(5), 402(e)(1)(B), and 408(d)(3)(A) of the Code)

Present Law

Under present law, a uniform benefit commencement date and required distribution rules are provided for benefits under all qualified plans (secs. 401(a) and 403(a)), IRAs (sec. 408), tax-sheltered annuities (sec. 403(b)), and eligible deferred compensation plans of State and local governments and tax-exempt employers (sec. 457 plans).

The Act repealed the provisions that prohibited rollover distributions by or on behalf of 5-percent owners to another qualified plan. However, the Act did not repeal the provision that prohibited a 5-percent owner from rolling over a qualified plan distribution into a conduit IRA and subsequently rolling the distribution over into another qualified plan.

Explanation of Provision

The bill clarifies that a distribution from a qualified plan and corresponding distribution to an IRA that results in any portion of a distribution being excluded from gross income under the rollover provisions is treated as a rollover distribution for purposes of the IRA rollover provisions.

The bill deletes the IRA rollover restriction under which certain distributions from IRAs with respect to 5-percent owners are not treated as rollover distributions for purposes of the IRA rules. This provision is effective for rollover distributions made in taxable years beginning after December 31, 1986. Thus, the bill clarifies that, as is the case with other taxpayers, 5-percent owners may rollover a qualified plan distribution into an IRA and subsequently roll the amount distributed from the IRA into another qualified plan. Different rules for 5-percent owners and other taxpayers are no longer necessary under the Act because all distributions from qualified plans are generally subject to the early withdrawal tax formerly applicable only to distributions to 5-percent owners.

Further, the bill provides that, notwithstanding any other provision of law, a plan or contract is permitted (except as provided in regulations prescribed by the Secretary) to incorporate by reference the uniform benefit commencement date and the required distribution rules for qualified plans (sec. 401(a)(9)).

It is further intended that an employee who has not retired from an employer prior to 1989, but has attained age 70½ prior to 1989, is considered to have attained age 70½ in 1989 for purposes of applying the new uniform benefit commencement rule to a plan maintained by the employer.

2. Tax treatment of distributions (sec. 6671A(b) of the bill, sec. 1122 of the Reform Act, and secs. 72, 402, and 414 of the Code)

The Act generally (1) phased out long-term capital gains treatment over 6 years (except for certain grandfathered individuals); (2) eliminated 10-year forward averaging (except for certain grandfathered individuals) and allowed 5-year forward averaging under more limited circumstances; (3) modified the prior-law basis recovery rules for amounts distributed prior to a participant's annuity starting date; (4) repealed the special 3-year basis recovery rule; (5) modified the general basis recovery rules for distributions from an annuity; (6) provided basis recovery rules for distributions from an IRA when an individual has made nondeductible IRA distributions; (7) repealed the constructive receipt rule for tax-sheltered annuities; and (8) modified the rules relating to rollovers of partial distributions.

a. Basis recovery rules

Present Law

The Act modified the basis recovery rules applicable to distributions from plans to which after-tax employee distributions have been made by (1) eliminating the 3-year basis recovery rule for distributions on or after the annuity starting date and (2) requiring, with respect to distributions prior to the annuity starting date, that basis be recovered on a pro-rata basis.

Further, present law limits the total amount that an employee may exclude from income as a recovery of basis to the total amount of the emplolyee's basis. If benefits cease prior to the date the basis has been fully recovered, the amount of unrecovered basis is allowed as a deduction to the annuitant for his or her last taxable year. These modifications of the basis recovery rules are effective with respect to an individual whose annuity starting date is after July 1, 1986.

Under the Act, employee contributions to a defined contribution plan (and the income attributable thereto) may be treated as a separate contract for purposes of the basis recovery rules.

Under present law, a special basis recovery rule applies with respect to a plan substantially all the contributions to which are employee contributions (sec. 72(e)(7)). Under this special rule, distributions from such a plan are treated first as a return of taxable amounts under the plan.

Explanation of Provision

The bill provides that, if employee contributions (and the income attributable thereto) under a defined benefit plan as defined contribution plan (sec. 14(k)), then such separate account is also treated as a defined contribution plan for purposes of the basis recovery rules. The bill clarifies that this separate contract treatment applies without regard to whether the distribution is received as an annuity.

The bill repeals the special basis recovery rules that apply in the case of a plan substantially all of the contributions to which are employee contributions.

The bill provides that the effective date of the provision allowing a deduction in the last taxable year of the annuitant for unrecovered basis is effective for individuals whose annuity starting date is after July 1, 1986. Thus, in the case of an individual whose annuity starting date is after July 1, 1986, and before January 1, 1987, the rule limiting the amount of basis recovered does not apply, but the rule providing a deduction at death for unrecovered basis does apply. This rule is provided because it would be unfair to deny individuals who lost the benefit of the 3-year basis recovery rule the benefit of the deduction for unrecovered basis at death.

The bill provides a special rule with respect to plans maintained by a State that, on May 5, 1986, provided for withdrawals by the employee of employee contributions (other than as an annuity). In the case of such plans, the modifications in the recovery rules for distributions prior to the annuity starting date apply only to the extent that the amount distributed exceeds the employee's basis as of December 31, 1986. In addition, amounts received (other than as an annuity) before or with the first annuity payment are treated as having been recovered before the annuity starting date.

b. Rollovers

Present Law

The Act modified the rules relating to rollovers of partial distributions. Under the Act, partial distributions may be rolled over only if the distributions would satisfy the requirements for a lump-sum distribution and if the distribution is made on account of the death of the employee, the employee's separation from service, or is made after the employee has become disabled. The rule aggregating plans of the same kind applies for purposes of determining whether the amount distributed constitutes 50 percent of the balance to the credit of an employee (sec. 402(e)(4)(C)).

The Act contained a special rule permitting certain amounts deposited in certain financially distressed financial institutions to be rolled over notwithstanding that the rollover does not occur within 60 days of the date of the original distribution. Under this rule, the

60-day period does not include periods while the deposit is frozen. In addition, the individual has a minimum of 10 days after the release of the frozen deposit to complete the rollover.

The Act also provided that distributions from ESOP made pursuant to the diversification requirements applicable to ESOPs (added by the Act) are treated as partial distributions eligible for rollover treatment.

Explanation of Provision

The bill repeals the provisions of the 1986 Act relating to rollovers of partial distributions, other than the rule permitting distributions made to satisfy the diversification requirement to be rolled over. Thus, under the bill, as under ther law prior to the 1986 Act, a partial distribution may be rolled over only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee in the plan (determined immediately before such distribution and without aggregating plans of the same type), (2) the distribution is not one of a series of periodic payments, and (3) the employee elects rollover treatment (in accordance with regulations). The bill reinstates the pre-1986 Act requirements because the provisions in the Act, particularly the rule aggregating plans of the same type, unduly restricted the situations in which partial distributions could be rolled over. In addition, the bill provides that a partial distribution may be rolled over only if the distribution is made (1) on account of the employee's death, (2) on account of the employee's separation from service, or (3) after the employee has become disabled (within the meaning of sec. 72(m)(7)).

The committee intends that, for purposes of the rule denying rollover treatment in the case of a distribution that is part of a series of periodic payments, the mere fect that payments to an employee are made in more than one taxable year does not automatically mean that they constitute a series of periodic payments. For example, it is not uncommon for an employer to make a lump-sum distribution to an employee in one taxable year and discover a calculation error in the following taxable year that requires another distribution to the employee. The committee intends, under these circumstances, that the first distribution is to be treated as a lump-sum distribution (as under present law) and the second distribution is to be treated as a partial distribution eligible for rollover treatment. The partial distributions rollover rules were originally enacted because of employer errors in calculating the lump-sum distributions to which employees are entitled and the committee expects the Secretary's interpretation of the rules to be consistent with this intent.

The bill retains the rule permitting rollover of a distribution made to satisfy the diversification requirements (sec. 401(a)(28) if the employee elects such treatment and provides that if amounts are rolled over pursuant to these rules is not prohibited from election income averaging for a subsequent lump-sum distribution.

The bill clarifies that the special rule for frozen deposits applies only to amounts that are frozen within 60 days of the date that the amounts are distributed from the plan.

c. Net unrealized appreciation

Present Law

Under present law, to the extent provided by the Secretary, a taxpayer may elect to waive the special treatment of net unrealized appreciation in employer securities with respect to a lump-sum distribution prior to the time the distribution is received.

Explanation of Provision

Under the bill, the election to waive net unrealized appreciation treatment with respect to a lump-sum distribution is to be made on the tax return on which the distribution is required to be included in gross income if the special treatment is waived. This change is designed to give taxpayers more time to determine whether or not they make the election. An election to waive the special treatment of net unrealized appreciation does not preclude an election for income averaging.

d. Income averaging and long-term capital gains treatment

Present Law

The Act generally repealed 10-year forward averaging, phased out pre-1974 capital gains treatment over a 6-year period, and made 5-year forward averaging (calculated in the same manner as 10-year averaging under prior law) available for 1 lump-sum distribution with respect to an employee on or after the taxpayer attains age 59⅓.

In addition, the Act provide a special transition rule under which an individual who had attained age 50 by January 1, 1986, is entitled to make 1 election to use 5-year averaging (under the new tax rates) or 10-year averaging (under the prior-law tax rates) with respect to a single lump-sum distribution. Similarly, such a grandfathered individual could elect capital gains treatment with respect to a lump-sum distribution without regard to the 6-year phaseout of capital gains treatment. Under this special capital gains election, the portion of a lump-sum distribution entitled to capital gains treatment is taxed at a rate of 20 percent, regardless of the maximum effective capital gains rate under prior law.

Under prior law, the amount subject to tax under the income averaging rule was calculated by adding in the zero bracket amount. This addition was eliminated by the Act because the zero bracket amount is eliminated generally.

Explanation of Provision

The bill clarifies that a 5-year averaging election may be made by an individual, trust, or estate for a lump-sum distribution received with respect to an employee who had attained age 59½. In addition, the bill provides that an income averaging election or election of long-term capital gains treatment under the special transition rules may be made by any individual, trust, or estate with respect to an employee who had attained age 50 by January 1, 1986.

The bill also clarifies that, for purposes of 5-year income averaging, the phaseout of the 15-percent bracket applies.

Further, under the bill, the election under the special transition rule of 10-year averaging (under the prior-law tax rates) is to take into account the prior-law zero bracket amount. This change is needed to preserve the prior-law treatment for persons who elect the grandfather rule.

The bill clarifies that a capital gains election made under either of the special transition rules is treated as an income averaging election (within meaning of sec. 402(e)(4)(B)) for all purposes under the Code (including, of example, sec. 4980A relating to the 15-percent tax on excess distributions).

3. Additional income tax on early withdrawals (sec. 10211A(c) of the bill, sec. 1123 of the Reform Act, and sec. 72 of the Code)

The Act (1) modified the withdrawal restrictions applicable to qualified cash or deferred arrangements, tax-sheltered annuities, and tax-sheltered custodial accounts, and (2) imposed a 10-percent additional income tax on certain early withdrawals from qualified retirement plans.

A qualified retirement plan is defined to include (1) a qualified plan (sec. 401(a)), (2) a qualified annuity plan (sec. 403(a)), (3) a tax-sheltered annuity or custodial account (sec. 403(b)), or (4) an individual retirement arrangement (IRA) (sec. 408).

a. Early retirement exception

Present Law

Under the Act, the additional income tax on early withdrawals does not apply to distributions that are made to an employee after separation from service on account of early retirement under the plan after attainment of age 55. This exception does not apply to distributions from an IRA.

In all cases, the exception applies only if the participant has attained age 55 on or before separation from service. Thus, for example, the exception does not apply to a participant who separates from service at age 52 and begins receiving benefits at or after age 55.

Explanation of Provision

The bill modifies the early retirement exception to apply in any case in which an employee receives a distribution on account of separation from service after attainment of age 55, rather than requiring an early retirement under the plan. The intent of this provision is to eliminate what is considered a requirement that has little substantive effect, but could require plan amendment.

The modified early retirement exception continues to apply if the employee returns to work for the same employer (or for a different employer) as long as the employee did, in fact, separate from service before the plan distribution. Of course, any short-term separation is to be closely scrutinized to determine if it is a bona fide, indefinite separation from service that would qualify for this exception to the early withdrawal tax.

As under present law, this exception does not apply to IRA distributions.

b. Exception for distributions from ESOPs

Present Law

Under present law, certain contributions from an employee stock ownership plan (ESOP) are exempt from the additional income tax on early withdrawals. Under the Act, this exception applies to the extent that, on average, a majority of assets in the plan have been invested in employer securities for the 5-plan year period preceding the plan year in which the distribution is made and the exception does not apply to any distribution attributable to assets that have not been invested in employer securities at all times during such 5-plan year period.

For purposes of determining whether the holding period requirement has been satisfied, the IRS has stated that an employee's benefits will be treated as invested in employer securities for the period (not greater than 90 days) beginning on the date that employer securities are sold pursuant to a corporate reorganization and ending on the date that employer securities are required to replace the securities that were sold (Notice 87-13). In addition, the IRS has taken the position that certain benefits held in cash and cash equivalents are treated as being invested in employer securities.

Explanation of Provision

The bill modifies the ESOP exception to the additional income tax on early withdrawals to provide that the exception is available to the extent that a distribution from an ESOP is attributable to assets that have been invested, at all times, in employer securities (as defined in sec. 409(1)) that satisfy the requirements of sections 409 and 401(a)(28) for the 5-plan year period immediately preceding the plan year in which the distribution occurs. Employer securities that are transferred to an ESOP from another plan are also eligible for the exception to the early withdrawal tax as long as the holding period requirement is satisfied with respect to such employer securities taking into account the time such employer securities were held in the other plan.

For example, assume that employer securities that were transferred from a profit-sharing plan are held in an ESOP for the 1-plan year period immediately preceding the plan year in which the distribution is made. If the profit-sharing plan met the requirements of section 401(a)(28) and 409 with respect to the employer securities for the 4-plan year period immediately prior to the transfer to the ESOP, then the holding period requirement is satisfied. On the other hand, if the profit-sharing plan did not satisfy sections 401(a)(28) and 409 with respect to the transferred securities, the holding period requirement would not be satisfied and the exception to the early withdrawal tax does not apply to the transferred amounts. The bill clarifies that the employer securities are not required to be subject to the requirements of sections 401(a)(28) and 409 prior to the time those requirements are effective.

These changes are designed to ensure that the ESOP exception only applies with respect to employer securities that are subject to the section 409 rules applicable to ESOPs. The committee does not intend these rules to override the administrative position of the IRS that certain benefits are treated as being invested in employer securities.

Under the bill, an ESOP includes both an ESOP described in section 4975(e)(7) and a tax-credit ESOP (within the meaning of sec. 409).

c. Exceptions not applicable to IRAs

Present Law

Under present law, certain exceptions to the additional income tax on early withdrawals are not applicable to distributions from IRAs. These exceptions include the early retirement, medical expense, and ESOP exceptions. The exception for distributions pursuant to a qualified domestic relations order applies to an IRA only to the extent the IRA is subject to the rules relating to qualified domestic relations orders.

Explanation of Provision

Because the rules relating to qualified domestic relations orders do not apply to IRAs, the bill clarifies that the exception to the early withdrawal tax in the case of distributions pursuant to a qualified domestic relations order does not apply to IRA distributions. This is consistent with the pre-Reform Act law applicable to IRAs.

d. Deferred annuity contracts

Present Law

Under present law, early withdrawals from a deferred annuity contract generally are subject to a 10-percent additional income tax in the same manner as early withdrawals from a qualified plan.

Certain exception to the 10-percent early withdrawal tax are provided. An exception is provided for a distribution that is part of a series of substantially equal periodic payments (not less frequently than annually) made over the life of life expectancy of the taxpayer or the lives or life expenctancies of the taxpayer and the taxpayer's beneficiary.

If distributions to an individual are not subject to the tax because of application of the substantially equal payment exception, the tax will nevertheless be imposed if the employee changes the distribution method prior to age 59½ to a method that does not qualify for the exception. The additional tax will be imposed in the first taxable year in which the modification is made and will be equal to the tax (as determined under regulations) that would have been imposed had the exception not applied.

In addition, the recapture tax will apply if an employee does not receive payments under a method that qualifies for the exception for at least 5 years, even if the method of distribution is modified after the employee attains age 59½. Thus, for example, if an employee begins receiving payments in substantially equal installments at age 56, and alters the distribution method to a form that does not qualify for the exception prior to attainment of age 61, the additional tax will be imposed on amounts distributed prior to age 59½ as if the exception had not applied. The additional tax will not be imposed on amounts distributed after attainment of age 59½.

The modifications to the additional income tax on early withdrawals under a deferred annuity apply to all distributions made under the annuity in taxable years beginning after December 31, 1986.

Explanation of Provision

The bill clarifies that the substantially equal payment exception and the recapture tax for distributions in violation of the substantially equal payment exception are not limited to distributions to employees under an employer-maintained pension plan. Rather, the exception and recapture tax apply to all distributions under a deferred annuity whether or not received by an invidiual with respect to the individual's status as an employee.

Further, the bill clarifies that the additional income tax applicable to early withdrawal from a deferred annuity (sec. 72(q)) does not apply if a distribution is otherwise subject to the early withdrawal rules for qualified plans (sec. 72(t)), whether or not an exception to the additional income tax on early withdrawals from a qualified plan applies under section 72(t)(2).

The bill modifies the effective date of the provision relating to the additional income tax on early withdrawals under a deferred annuity so that the changes in the early withdrawal tax does not apply to any distribution under an annuity contract if (1) as of March 1, 1986, payments were being made under such contract pursuant to a written election providing a specific schedule for the distribution of the taxpayer's interest in such contract, and (2) such distribution is made pursuant to such written election.

e. Substantially equal payment exception

Present Law

Under present law, an exception to the 10-percent additional income tax on early withdrawals from a qualified plan or deferred annuity is provided for a distribution that is part of a series of substantially equal periodic payments made (not less frequently than annually) over the life or life expectancy of the taxpayer or the lives or life expectancies of the taxpayer and the taxpayer's beneficiary.

Explanation of Provision

The bill provides that the substantially equal payment exception is available only if the beneficiary whose life or life expectancy is taken into account in determining whether the exception is satisfied is a designated beneficiary of the individual. For this purpose, rules similar to those applicable under section 401(a)(9) are to apply.

f. Qualified voluntary employee contributions

Present Law

Under prior law, an employee who was a participant in a qualified plan, tax-sheltered annuity program, or government plan was allowed a deduction for qualified voluntary employee contributions (QVECs) made by or on behalf of the employee to the plan. The Act repealed the deduction allowed for QVECs, but permitted contributions that had been made prior to repeal to continue to be held under the plan.

Under present law, in addition to the additional income tax on early withdrawals under qualified plans (sec. 72(t)), a 10-percent additional income tax is also imposed on early withdrawals of QVECs (sec. 72(o)).

Explanation of Provision

In order to prevent the imposition of two 10-percent early withdrawal taxes on distributions attributable to QVECs, the bill repeals the 10-percent early withdrawal tax applicable only to QVECs. Thus QVECs are treated as distributions from a qualified plan for purposes of the 10-percent additional income tax on early withdrawals and are eligible for any of the applicable exceptions otherwise available for distributions from qualified plans.

g. Tax-sheltered annuities

Present Law

The Act provided that the withdrawal restrictions applicable to tax-sheltered custodial accounts generally were extended to elective deferrals and earnings on elective deferrals under other tax-sheltered annuities. Under these rules, early distributions from elective deferrals and earnings on elective deferrals under a tax-sheltered annuity are prohibited unless the withdrawal is made on account of death, disability, separation from service, or attainment of age 5912. In addition, withdrawals on account of hardship from a tax-sheltered annuity or custodial account are permitted only to the extent of the contributions made pursuant to a salary reduction agreement (but not earnings on those contributions).

Under the Act, the provisions restricting distributions attributable to elective deferrals (and earnings thereon) under a tax-sheltered annuity are effective for taxable years beginning after December 31, 1988.

Explanation of Provision

The bill provides that the distribution restrictions added by the Act with respect to tax-sheltered annuities are effective for years beginning after December 31, 1988, but only with respect to distributions from such tax-sheltered annuities that are attributable to assets that were not held as of the close of the last year beginning before January 1, 1989. Thus, the new rules apply to contributions made in years beginning after December 31, 1988, and to earnings on those contributions and on amounts held as of the last year beginning before January 1, 1989.

h. Involuntary cashouts under a qualified plan

Present Law

Under present law, a pension plan may immediately distribute the present value of an employee's benefit under the plan if the employee separates from service with the employer and the present value of the benefit does not exceed $3,500. It was unclear under the Act whether the 10-percent additional income tax on early withdrawals under a qualified plan applies in the case of such involuntary cashouts of benefits.

Explanation of Provision

The bill clarifies that the additional income tax on early withdrawals under a qualified plan is to apply in the case of an involuntary cashout under section 411(a)(11) or 417(e) . . . Of course, the early withdrawal tax does not apply if the amount of the benefit paid to an employee is rolled over to another qualified plan or an IRA.

4. Transition rule (sec. 6671A(d) of the bill and sec. 1124 of the Reform Act)

Present Law

Under the Act, a special transition rule was provided in the case of employees who separated from service during 1986. In the case of such an employee, if the employee received a lump-sum distribution before March 16, 1987, on account of the separation from service, then the employee could treat the lump-sum distributioin as received in 1986 for all purposes. Thus, the lump-sum distribution is includible in income in 1986 and, assuming the employee is otherwise eligible, the employee can elect 10-year income averaging with respect to the lump-sum distribution.

Explanation of Provision

Under the bill, the special transition rule is amended to apply in the case of an employee who dies, separates from service, or becomes disabled at any time before 1987, including years prior to 1986. In the case of such an employee, if an individual, trust, or estate receives a lump-sum distribution with respect to the employee after December 31, 1986, and before March 16, 1987, on account of the employee's death, separation from service, or disability, then the individual, trust, or estate may treat the distribution as if it was received in 1986 for all purposes under the Code. This restructuring of the rule is intended to make it clear that (1) an individual, trust, or estate may elect the transition rule with respect to a lump-sum distribution received for an employee who otherwise would qualify for the transition rule and (2) a separation from service on account of death or disability is also a separation from service for purposes of the transition rule.

The bill also clarifies that, for purposes of the transition rule, the 5 years of participation requirement (sec. 402(e)(4)(H)) and the election requirement (sec. 402(e)(4)(B)) applicable to lump-sum distributions do not apply.

5. Loans from qualified plans (sec. 6671A(h) of the bill, sec. 1134 of the Reform Act, and sec. 72(p) of the Code)

Present Law

Under present law, an individual is permitted to borrow from a qualified plan in which the individual participates (and to use his or her accrued benefit as security for the loan) if certain requirements are satisfied.

Subject to certain exceptions, a loan to a plan participant is treated as a taxable distribution of plan benefits under present law.

Present law provides for the disallowance of the deduction for interest paid on a loan from a qualified plan by (1) all employees on loans secured by elective deferrals (or the income attributable thereto) under a qualified cash or deferred arrangement or tax-sheltered annuity or custodial account, and (2) key employees with respect to loans from any qualified plan or tax-sheltered annuity or custodial account.

Explanation of Provision

Present law does not expressly prescribe the period during which the interest deduction disallowance rule applies. Therefore, the bill clarifies the period during which the interest deductioin disallowance rule applies to include the period (1) on or after the first day on which the individual to whom a loan is made is a key employee or (2) the loan is secured by elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity or custodial account.

D. Limits on Tax Deferral Under Qualified Plans

1. Overall limits on contributions and benefits under qualified plans (sec. 6671(d) of the bill, sec. 1106 of the Reform Act, and secs. 404 and 415 of the Code)

The Act revised the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs. In addition, the Act (1) provides special rules with respect to plans of governmental employers and tax-exempt employers, (2) permitted a defined benefit pension plan to maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary retirement benefit under the plan, (3) imposed a limit on the amount of compensation that may be taken into account for deduction purposes, and (4) modified the rules relating to the phasein of the limits on annual benefits under a defined benefit pension plan.

a. Includible compensation

Present Law

Under present law, not more than $200,000 of compensation of an employee may be taken into account under a qualified plan. This $200,000 limit on includible compensation applies for most purposes under the Code, including the provisions relating to nondiscrimination requirements and to deductibility. Consequently, no more than $200,000 of an employee's compensation for a year may be taken into account in computing deductions for plan contributions.

This $200,000 limit is to be adjusted, beginning in 1990, for post-1988 cost-of-living increases at the time and in the manner provided for the adjustment of the limits on annual benefits under a qualified defined benefit pension plan (sec. 415(d)).

Explanation of Provision

Under the bill, increases in the $200,000 limit on includible compensation may not be taken into account before they occur in determining the deduction limit for contributions to a qualified plan. Similarly, such increases may not be taken into account before they occur in calculating the full funding limitation (as determined under sec. 412).

Further, the bill makes it clear that the $200,000 cap on includible compensation does not apply, under present law, in the case of an employer's deduction for benefits provided under a nonqualified deferred compensation plan.

b. Eligibility to receive maximum benefits

Present Law

Under the Act, a reduced dollar limit applies to participants who have completed fewer than 10 years of participation in a defined benefit pension plan (sec. 415(b)(5)). With respect to such participants, the dollar limit is determined by multiplying the otherwise applicable dollar limit by a fraction. The numerator of the fraction is the number of years (including a fractional year) of participation in the plan completed by the employee. The denominator of the fraction is 10.

The Act provides that, to the extent provided in regulations, the reduction based on years of participation is to be applied separately with respect to each change in the benefit structure of a plan by a plan amendment or otherwise as if such change is a new plan. Such regulations are to take into account whether the change is a benefit improvement or reduction. The phasein for each change in benefit structure begins on the date a plan amendment creating the change is effective.

A separate phase-in rule applies to the 100-percent of compensation limit (sec. 415(b)(1)(B)) and to the $10,000 limit on de minimis benefits (sec. 415(b)(4)). Under this rule, those limits are phased in on the basis of years of service rather than years of participation.

Explanation of Provision

The bill clarifies that the rule requiring separate phaseins for each change in benefit structure under a plan does not apply in the case of the phasein of the 100 percent of compensation limit or the $10,000 limit on de minimis benefits.

The bill further provides that, for purposes of the combined limit on contributions and benefits (sec. 415(e)), the dollar limit on benefits under a defined benefit pension plan is to be phased in over 10 years of service, rather than 10 years of participation. Correspondingly, the rule requiring separate phasein for such change in benefit structure does not apply for purposes of the combined limit.

c. Qualified cost-of-living arrangements

Present Law

In general

The Act permitted a defined benefit pension plan to maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary benefit under the plan. If the arrangement is qualified, then an employee contribution under the arrangement is not be treated as an annual addition in applying the separate limit on annual additions under defined contribution plans (sec. 415(c)), but is to be treated as an annual addition for purposes of applying the combined plan limit (sec. 415(e)). Further, under a qualified arrangement, the benefit attributable to an employee's contribution is to be treated as a benefit derived from employer contributions for purposes of applying the limit on annual benefits (sec. 415(b)). Under the Act, a qualified cost-of-living arrangement is required to comply with the dollar limits, election procedures, and nondiscrimination requirements of the Act.

Limit requirement

A qualified cost-of-living arrangement satisfies the limit requirement provided by the Act if it (1) limits cost-of-living adjustments to those cost-of-living increases occurring after the annuity starting date, and (2) bases the cost-of-living adjustment on average cost-of-living increases determined by reference to 1 or more indices prescribed by the Secretary, except that the plan can provide a minimum increase for each year of 3 percent of the original retirement benefit. It was unclear, under the Act, whether a plan could provide for a minimum increase for each year of 3 percent of the retirement benefit as adjusted under the cost-of-living arrangement in prior years.

Election requirement

A qualified cost-of-living arrangement meets the election requirements if it provides that participation in the qualified cost-of-living arrangement is elective and permits participants to make an election in (1) the year in which the participant attains the age at which retirement benefits are first available under the defined benefit pension plan; (2) the year in which the participant separates from service; or (3) both such years.

Explanation of Provision

Limit requirement

The bill clarifies that a plan will not fail to satisfy the limit requirement if it provides for a minimum increase for each year of 3 percent of the retirement benefit (determined without regard to the current year's increase). Thus, the minimum increase may be 3 percent of the retirement benefit as adjusted under the cost-of-living arrangement in prior years.

Election requirement

Under the bill, a plan may permit participants to make an election under the qualified cost-of-living arrangement during any year, as long as the plan permits elections to be made at least in the year in which the participant (1) attains the earliest retirement age under the defined benefit pension plan (determined without regard to any requirement of separation from service), or (2) separates from service.

d. Computation of combined limit

Present Law

Under a transition rule of the Act, in the case of a plan that satisfied the requirements of the overall limits on contributions and benefits (sec. 415) for its last year beginning before January 1, 1987, Treasury regulations are to provide for the determination of an amount that is to be subtracted from the numerator of the defined contribution fraction so that the sum of the defined benefit plan fraction and the defined contribution plan fraction (sec. 415(e)(1)) does not exceed 1.0 for such year. This amount to be subtracted is not to exceed the numerator of the fraction.

Explanation of Provision

The bill clarifies that the adjustment to the sum of the defined benefit plan fraction and the defined contribution fraction so that such sum does not exceed 1.0 for purposes of this transition rule is determined as if the new rules were in effect for the last year beginning before January 1, 1987.

2. Deduction limits for qualified plans (sec. 6671A(e) of the bill, sec. 1131 of the Reform Act, and sec. 4972 of the Code)

Present Law

In general

Under present law, a 10-percent nondeductible excise tax is imposed on nondeductible contributions to a qualified plan (secs. 401(a) and 403(a)) or simplified employee pension (SEP) (sec. 408(k)).

Amount of nondeductible contributions

The contributions to a plan that are subject to the excise on nondeductible contributions are (1) the amounts contributed to a qualified employer plan by the employer for the taxable year in excess of the amount allowable as a deduction for the taxable year, plus

(2) the unapplied amounts in the preceding taxable year. The unapplied amounts in the preceding taxable year are the amounts subject to the excise tax in the preceding year reduced by the sum of (1) the portion of the amounts that are returned to the employer during the taxable year, and (2) the portion of such unapplied amounts that are deductible during the current taxable year.

Time for determination of nondeductible contributions

Nondeductible contributions for a year are determined as of the close of the employer's taxable year. A contribution made on account of a year that is made after the close of the year is to be taken into account in determining the level of excess contributions for the year with respect to which the contribution is made.

Nondeductible contributions to underfunded plans

Under the Act, the excise tax on nondeductible contributions applies to nondeductible contributions to underfunded plans.

Definition of employer

The excise tax on nondeductible contributions is imposed on the employer. Under present law, in the case of a plan that provides contributions or benefits for employees some or all of whom are self-employed individuals (sec. 401(c)(1)), an individual who owns the entire interest in an unincorporated trade or business is treated as the employer. Also, under present law, a partnership is to be treated as the employer of each partner who is considered to be an employee (sec. 401(c)(1)).

Under the Act, an employer to whom the excise tax on nondeductible contributions applies includes an employer that is a tax-exempt organization.

Combinations of pension and other plans

Under present law, if an employer contributes to 1 or more qualified defined contribution plans (i.e., 1 or more qualified money purchase pension plans, profit-sharing plans, or stock bonus plans) and 1 or more qualified defined benefit pension plans for a taxable year, then the amount deductible in that taxable year (under sec. 404(a)(7)) is not to exceed the greater of (1) 25 percent of the compensation otherwise paid or accrued during the taxable year to the employees who benefit under the plans, or (2) the amount of contributions made to or under the defined benefit pension plan or plans to the extent necessary to meet the minimum funding standard for that plan (sec. 412).

Present law coordinates the deduction limits for employer contributions to a simplified employee pension (SEP) with the deduction limit applicable to profit-sharing or stock bonus plans.

Explanation of Provision

Amount of nondeductible contributions

Under the bill, the definition of nondeductible contributions includes, for purposes of the excise tax, contributions allocable to the purchase of life, accident, health, or other insurance on behalf of a self-employed individual, but only to the extent that the contributions would be nondeductible without regard to the special rule limiting deductions for such contributions (sec. 404(e)).

The bill clarifies that the amount allowable as a deduction (without regard to sec. 404(e)) for any taxable year is treated as coming first from carryforwards to the taxable year from preceding taxable years (in order of time) and then from employer contributions made during the taxable year.

Further, under the bill, the unapplied amounts in the preceding taxable year do not include nondeductible contributions made for years prior to the effective date of the excise tax on nondeductible contributions. However, carryforwards from pre-effective date years are applied first against the deduction limit (without regard to sec. 404(e)) in determining whether contributions after the effective date are subject to the excise tax.

Time for determination of nondeductible contributions

Because the determination of nondeductible contributions as of the end of a taxable year includes contributions made after the close of the taxable year with respect to the year, the bill provides that contributions that are returned (together with the income allocable thereto) to an employer (to the extent permitted under sec. 401(a)(2)) by the due date of plan contributions for the year (sec. 404(a)(6)) are not treated as nondeductible contributions subject to the excise tax.

Nondeductible contributions to underfunded plans

Under the bill, the excise tax on nondeductible contributions does not apply in the case of a plan that is underfunded and to which Title IV of ERISA applies. A plan is underfunded if, as of the close of the plan year with or within which the taxable year begins, (1) the liabilities of the plan (determined as if the plan were terminated on that date) exceed (2) the assets of the plan. In the case of such an underfunded plan, contributions for a plan year up to the excess calculated under the preceding sentence are not subject to the excise tax even if such contributions are not deductible by the employer.

Definition of employer

The bill provides that the excise tax on nondeductible contributions does not apply in the case of an employer that has been exempt from income tax at all times. Under rules to be prescribed by the Secretary, this exception does not apply to the extent that the employer has been subject to unrelated business income tax or has otherwise derived a tax benefit from the qualified plan.

The original rationale for the excise tax was that, by making nondeductible contributions to qualified plans, often the benefit of tax-free growth on the amounts contributed outweighed the delay in the employer's deduction for plan contributions. Such an incentive to make nondeductible contributions increased the likelihood that employers would use qualified plans as a tax-favored savings vehicle, particularly in the case of small plans that primarily benefit the owners of the employer. The excise tax on revisions may not offset the value of the deferall of tax on earnings on nondeductible contributions to qualified plans.

Such a rational does not apply in the case of contributions to plans maintained by governments or tax-exempt organizations. In the case of such plans, the employer generally has no incentive to make plan contributions solely to receive the benefit of tax-free growth because the employer could hold the funds directly without incurring current income tax. Thus, an incentive to use a qualified plan as a tax-favored savings vehicle generally does not exist in the case of a qualified plan maintained by a government or tax-exempt employer.

Combinations of pension and other plans

The bill clarifies that the limit on an employer's deduction for contributions to a combination of qualified plans (sec. 404(a)(7)) also applies in the case of (1) a combination of a profit-sharing or stock bonus plan and a money purchase pension plan or an annuity plan (sec. 404(a)(2)), and (2) a money purchase pension plan and an annuity plan. In addition, for purposes of section 404(a)(7), the bill treats a simplified employee pension (SEP) as a separate profit-sharing or stock bonus plan. Thus, a combination of a SEP and any other qualified plan is subject to section 404(a)(7).

Effective Date

The bill provides a delayed effective date for the changes in the deduction rules for plans maintained pursuant to a collective bargaining agreement (see the discussion in Part E, below).

3. Excise tax on reversion of qualified plan assets to employer (sec. 6671A(f) of the bill, sec. 1132 of the Reform Act, and sec. 4980 of the Code)

Present Law

In general

Under present law, a 10-percent excise tax is imposed on a reversion from a qualified plan. The excise tax is imposed on the employer maintaining the plan.

Present law defines a reversion as the amount of cash and the fair market value of other property received (directly or indirectly) by an employer from a qualified plan. No inference is to be drawn from the definition of a reversion as to the income tax consequences and the effect on a plan's qualified status of a transfer of assets from a qualified plan that has not been terminated to another qualified plan.

Special rule for assets transferred to ESOPs

Present law provides an exception to the excise tax on reversions in the case of asset reversions that are transferred from a defined benefit pension plan to an employee stock ownership plan (ESOP). The amount transferred is not includible in the income of the employer, nor is the amount transferred deductible by the employer as a plan contribution. No inference is to be drawn from this exception as to the circumstances in which asset transfers will or will not satisfy the exclusive benefit rule and any other applicable qualification requirements (e.g., sec. 401(a)(2) and 414(1)).

Under present law, the amount transferred to the ESOP is required to be used, within 90 days after the transfer, to acquire employer securities (as defined in sec. 409(1)) or to repay a loan the proceeds of which are or were used to acquire employer securities.

Employer securities acquired with the amounts transferred are to be allocated immediately under the plan to ESOP participants, subject to the limits under section 415. As provided under the plan, the amount transferred but not allocated in the year of transfer (by reasons of the limitation of sec. 415) may be held in a suspense account pending allocation (provided allocations of the amounts in the suspense account are made no more slowly than ratably over a 7-year period).

The employer securities acquired with the transferred assets are to be held under the plan until distributed to plan participants.

The special exception for transfers to an ESOP does not apply to transfers occurring on or after January 1, 1989, unless the transfer occurs on account of a plan termination before January 1, 1989.

Explanation of Provision

The bill clarifies that the exception to the excise tax on reversions in the case of transfers of assets to an ESOP applies to transfers to tax-credit ESOPs (sec. 409) as well as ESOPs described in section 4975(e)(7). Absent this clarification, a tax-credit ESOP would be required, in order to qualify for the ESOP exception, to add plan language applicable to leveraged ESOPs even if the ESOP did not have any outstanding loans.

The bill provides an exception to the rule that the employer securities acquired with transferred assets are to be held under the plan until distributed to plan participants. Under this exception, the transferred amounts are not required to be held in employer securities if a plan participant elects to diversify a portion of the 401(a)(28)) that includes such employer securities and diversification cannot be satisfied out of nontransferred assets.

In addition, the bill provides that, with respect to the allocation of employer securities acquired with transferred amounts (and amounts attributable thereto), the minimum amount required to be allocated to participants' accounts in the ESOP in the year in which the transfer occurs is not to be less than the lesser of (1) the maximum amount that could be allocated without violating the requirements of section 415, or (2) ⅛ of the shares acquired with the amounts transferred (and amounts attributable to such amounts). Thus, the requirement in the Reform Act stock acquired with that amounts transferred to an ESOP is required to be allocated in the year of transfer up to the maximum amount permitted to be allocated under the limits on contributions (sec. 415) is repealed.

If employer securities are held in a suspense account pending allocation under the foregoing rule, the bill clarifies that dividends of such securities are to be (1) allocated to the accounts of participants and beneficiaries, (2) paid to participants and beneficiaries in proportion to their account balances, or (3) used to repay any loans the proceeds of which were used to purchase employer securities.

The amounts held in the suspense account that are required to be allocated each year are to be allocated to participants' accounts before any other employer contributions are allocated. In other words, during the period that reversion amounts are held in a suspense account, the employer is not permitted to make additional contributions to the ESOP or any other plan to the extent that the contributions, when added to the amounts held in the suspense account which are required to be allocated each year, would exceed the limits on contributions (sec. 415).

The bill conforms the exception for transfers to ESOPs to the general rule that the employer is required to include the amount of any reversion in income. Under the bill, the exception to the income inclusion requirement applies to any reversion occurring after March 31, 1985, if the reversion is transferred to an ESOP, subject to the January 1, 1989, termination of the ESOPs exception.

Finally, the bill clarifies, by statute, that an employer is not entitled to an deduction or credit for any amount transferred to an ESOP to the extent that the special exception to the reversion tax applies to the transfer. This rule is added to prevent an employer from gaining a double tax benefit (i.e., granting a deduction or credit for previously deductible contributions) by transferring assets to an ESOP.

4. Excise tax on excess distributions from qualified retirement plans (sec. 6671A(g) of the bill, sec. 1133 of the Reform Act, and sec. 4981A of the Code)

Under the Act, an excise tax is imposed on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs. To the extent that aggregate annual distributions paid to a participant from such tax-favored retirement arrangements are excess distributions, the Act generally imposes an excise tax equal to 15 percent of the excess. The excise tax will be reduced by the amount of tax on the distribution under the provision applying a 10-percent additional income tax on early withdrawals (sec. 72(t)).

a. Definition of excess distributions

Present Law

Under the Act, excess distributions are defined as the aggregate amount of retirement distributions made with respect to any individual during any calendar year, to the extent such amount exceed $112,500 (adjusted at the same time and in the same manner as the dollar limitation on annual benefits under a defined benefit pension plan).

The Act provided a special elective grandfather rule with respect to benefits accrued as of August 1, 1986. If this grandfather rule is not elected, then the definition of excess distributions is the greater of (1) $112,500 (adjusted at the same time and in the same manner as the dollar limitation on annual benefits under a defined benefit pension plan) or (2) $150,000.

Explanation of Provision

The operation of the grandfather provision of the Act in effect overrode the general definition of excess distributions in the Act. Thus, the general definition of excess distributions is the aggregate amount of retirement distributions made with respect to any individual during any calendar year, to the extent such amounts exceed the greater of (1) $112,500 (adjusted at the same time and in the same manner as the dollar limitation on annual benefits under a defined benefit pension plan), or (2) $150,000. The bill restructures the provision to make the general rule clear.

b. Distributions subject to the tax

Present Law

In determining the amount of retirement distributions that are subject to the excise tax, aggregate annual distributions made with respect to an individual from all pension, profit-sharing, stock bonus, and annuity plans, IRAs, and tax-sheltered annuities generally are taken into account, regardless of the form of the distribution or the number of receipients.

Under the Act, however, certain amounts are excluded into determining such aggregate annual distributions. Excludable distributions include (1) amounts representing a return of an employee's after-tax contributions (but not earnings thereon) or other amounts that are treated as part of the employee's investment in the contract, (2) amounts excluded from the recipient's income because they are rolled over into another plan or an IRA, and (3) amounts excluded from the participant's income because they are payable to a former spouse pursuant to a qualified domestic relations order (sec. 414(p)) and includible in the spouse's income.

Explanation of Provision

The bill clarifies that the exception to the amounts taken into account in determining aggregate annual distributions under a plan for investment in the contract is not limited to an employee's investment in the contract under a qualified plan, but also includes an individual's investment in the contract under an IRA. The Act was not intended to limit the exception for investment in the contract to amounts received by employees in their capacity as such.

In addition, the bill provides that, in the case of an annuity contract that is distributed to an individual and not included in the individual's income when the contract is distributed, the distribution of the contract is disregarded in applying this excise tax. Rather, payments made under or received for such an annuity contract are treated as retirement distributions subject to the excise tax to the extent they are excess distributions.

In order to identify only those qualified plan distributions that represent a payment of a benefit under the plan, the bill provides that certain amounts returned to an employee under a qualified cash or deferred arrangement or a plan subject to the special nondiscrimination requirements for employee contributions and employer matching contributions are not treated as part of the aggregate annual distributions under a plan. Thus, under the bill, aggregate annual distributions do not include a distribution, with respect to an individual, of excess deferrals (as defined in sec. 402(g)), excess contributions (as defined in sec. 401(k)(8)), excess aggregate contributions (as defined in sec. 401(m)(6)), or certain amounts withdrawn from an IRA before the due date of the return (sec. 408(d)(4)).

Under the bill, the operation of community property laws is disregarded in determining the amount of aggregate annual distributions subject to the excise tax. Thus, just as a nonemployee spouse's interest in an employee spouse's pension benefit is not taken into account in determining the taxable income of an employee upon distribution from or under a qualified plan, a nonemployee spouse's interest in such distributions is also disregarded in determining aggregate annual retirement distributions subject to the excise tax.

c. Grandfather rule

Present Law

Under the Act, certain individuals may elect to be covered by a special grandfather rule that exempts from the excise tax benefits accrued as of August 1, 1986 (including benefits accrued under any arrangements distributions from which are subject to the tax). Under the grandfather, in the case of a defined contribution plan or IRA, the accrued benefit of a participant as of August 1, 1986, is the participant's accrued benefit on the date. In the case of a defined benefit pension plan, the accrued benefit as of August 1, 1986, is the present value of the participant's benefit under the plan, determined as if the participant separated from service on that date. Benefits accrued as of August 1, 1986, to which the participant does not have a nonforfeitable right are included in the definition of accrued benefits for purposes of the grandfather rule.

If the grandfather rule is elected, then for all purposes, the threshold for retirement distributions that are excess distributions is $112,500 (indexed), rather than the greater of $112,500 (indexed) or $150,000.

The election to use the grandfather rule is to be made on a return for a year beginning no later than January 1, 1988, and is to be made in such form and contain such information as the Secretary may prescribe. The election, once made, applies generally to all retirement distributions made with respect to an individual, including amounts subject to the special estate-level tax after the individual's death. In addition, if an individual dies before the end of the election period, the executor of the individual's estate may make the grandfather election.

The grandfather rule may only be elected with respect to an individual if, as of August 1, 1986, the present value of the individual's interests subject to the excess distribution tax (if such tax were in effect on that date) exceeds $562,500.

Explanation of Provision

Under the bill, for purposes of the grandfather rule, benefits accrued as of August 1, 1986, do not include amounts that, as of August 1, 1986, would not be distributions subject to the excise tax (if the tax were in effect on August 1, 1986) if distributed on that date. Thus, under the bill, an individual's accrued benefit, for purposes of the grandfather, does not include any portion of the accrued benefit that, as of August 1, 1986, (1) is payable to an alternate payee pursuant to a qualified domestic relations order (sec. 414(p)) if includible in the income of the alternate payee, or (2) is attributable to the individual's investment in the contract.

The bill clarifies that the grandfather rule is available if amounts are received with respect to an individual under (1) the general rule applicable to lifetime distributions, (2) the special rule for lump-sum distributions, or (3) the special estate tax rule discussed below. Further, the bill provides that an election may be made with respect to the grandfather treatment either on an income or estate tax return of the individual.

d. Post-death distributions

Present Law

The Act provided special rules to calculate the extent to which retirement distributions made with respect to an individual after the individual's death are excess distributions subject to the excise tax. In lieu of subjecting the post-death distributions (including distributions of death benefits) to the annual tax on excess distributions, the Act added an additional estate tax equal to 15 percent of the individual's excess retirement accumulation. After the estate tax is imposed, post-death distributions are disregarded entirely in applying the excise tax on excess distributions. Thus, beneficiaries who are receiving distributions (other than certain former spouses receiving benefits pursuant to a qualified domestic relations order) are not required to aggregate those amounts with any other retirement distributions received on their behalf.

The excess retirement accumulation is defined as the excess (if any) of the values of the decedent's interest in all qualified retirement plans, annuity plans, tax-sheltered annuities, and IRAs, over the present value of annual payments equal to the annual excess distribution ceiling for a period equal to the life expectancy of the individual immediately before death.

In calculating the amount of the excess retirement accumulation, the value of the decedent's interest in all qualified plans, tax-sheltered annuities, and IRAs will be taken into account regardless of the number of beneficiaries.

Explanation of Provision

The bill clarifies that, as under the general rule, the amount of the excess retirement accumulation with respect to an invididual for purposes of the special estate tax is determined without regard to community property laws. This rule is provided so that the treatment of post-death distributions is consistent with the treatment of distributions made with respect to an individual prior to death.

In addition, under the bill, benefits that represent the decedent's investment in the contract or amounts payable to an alternate payee and includible in the alternate payee's income are disregarded in determining the excess retirement accumulation (other than a spousal beneficiary who makes the special election described below).

The bill redefines the excess retirement accumulation to be the excess (if any) of the present value of the decedent's interests in all qualified retirement plans annuity plans, tax-sheltered annuities, and IRAs, over the present value (as determined under rules prescribed by the Secretary as of the applicable valuation date) of a single life annuity with annual payments equal to the annual excess distribution limit (as in effect for the year in which death occurs and as if the individual had not died). The bill provides that a decendent's interest in a plan or arrangement subject to the excess distribution tax generally does not include the decedent's interest as a beneficiary in a plan or arrangement for purposes of determining the excess retirement accumulation.

Under the bill, the excess retirement accumulation with respect to an individual does not include amounts that are death benefits payable with respect to such individual. Therefore, the bill provides that the excess retirement accumulation does not include the value of any death benefits payable by the plan immediately after death with respect to a decedent to the extent that the sum of such death benefits plus other benefits payable with respect to the decedent exceeds the total value of benefits payable with respect to the decedent immediately prior to death.

The bill clarifies that, with respect to this special estate-level tax, the tax may not be offset by any credits against the estate tax (such as the unified credit).

Further, the bill provides an exception to the general rule that the special estate-level tax applies to all excess retirement accumulations with respect to an individual and that, after the estate-level tax is imposed, a beneficiary receiving distributions with respect to the individual is not required to aggregate the amounts received with any other retirement distributions received by the beneficiary on the beneficiary's own behalf. Under this exception, if the spouse of an individual is the beneficiary of all retirement accumulations with respect to the individual, the spouse may elect, on a form attached to the estate tax return, (1) not to have the special estate-level tax apply and (2) for purposes of the general rule, to have the distributions received with respect to the individual aggregated with any distributions that the spouse receives on the spouse's own behalf. Thus, the amounts received with respect to the individual would be subject to the general excise tax on excess distributions to the extent that the amounts, when aggregated with the spouse's own benefits from or under qualified plans, tax-sheltered annuities, and IRAs, exceed the threshold for the excise tax. Because the spouse is treated as a participant, rather than as a beneficiary, if the election is made, the special rule that disregards a decedent's interests as a beneficiary in a qualified plan does not apply in determining the spouse's excess retirement accumulation.

For purposes of this exception to the estate-level tax, if 1 or more persons other than the spouse are beneficiaries of a de minimis portion of the interests with respect to the individual that otherwise would be subject to the estate-level tax, then the spouse is not treated as failing to receive all excess retirement accumulations with respect to the individual. Further, such de minimis amounts are not subject to the excise tax on excess distributions with respect to the decedent no to the special estate-level tax if the spouse makes the election described above. For purposes of this rule, an amount will not be considered de minimis if it exceeds 1 percent of the decedent's retirement accumulation.

The bill clarifies that the special estate tax on a decedent's excess retirement accumulation is not deductible against income in respect of the decedent (sec. 691). Rather, the bill provides that a deduction is allowed from the gross estate of the decedent for the special estate tax.

Under the bill, an executor of a decedent's estate is required to file an estate tax return if the special tax on excess retirement accumulations applies and without regard to whether a return would otherwise be required to be filed.

e. Effective date

Present Law

Under the Act, the provisions generally apply to distributions made after December 31, 1986. The special estate-level tax applies with respect to the estate of a decedent dying after December 31, 1986.

Explanation of Provision

The bill clarifies that the provisions do not apply to distributions with respect to a decedent who dies before January 1, 1987.

E. Miscellaneous Pension and Deferred Compensation Provisions

1. Discretionary contribution plans (sec. 6671A(j) of the bill, sec. 1136 of the Reform Act, and secs. 401(a)(27), 404, and 818 of the Code)

Present Law

Under present law, employer contributions to a profit-sharing plan are not limited to the employer's current or accumulated profits. Contributions to a money purchase pension plan are required to be fixed without reference to profits.

Explanation of Provision

Under the bill, in the case of a plan that is intended to be a money purchase pension plan or a profit-sharing plan, a trust forming part of such plan will not be qualified unless the plan designates such intent at such time and in such manner as the Secretary may prescribe. Of course, a plan amendment is not required to comply with this rule until such time as plan amendments generally are required under the Act (sec. 1140). Prior to such time, the Secretary may require designation in a different manner.

2. Time required for plan amendments (sec. 6671A(1) of the bill and sec. 1140 of the Reform Act)

Present Law

The Act generally allowed plans that operated in compliance with the new requirements of Title XI of the Act to delay the corresponding plan amendments to a specified time.

Explanation of Provision

The bill provides the same delayed amendment rules (other than those relating to a model amendment to be prescribed by the Internal Revenue Service) with respect to the plan amendments required by Title XVIII of the Act (the technical corrections title) or by the bill itself. This furthers the intent of Congress to ease the administrative burdens on plans by delaying the date required for certain amendments so that, in general, all required amendments can be made in a single year.

In addition, the bill provides that a collective bargaining agreement is not to be treated as terminated merely because a plan is amended pursuant to the agreement to meet the requirements of Title XI or Title XVIII of the Act. The bill does not intend to create an inference that such an amendment otherwise would be considered a termination, or that an amendment made solely to conform a plan to a requirement added by another Act is considered a termination.

3. Federal Thrift Savings Plan (sec. 6671A(n) of the bill, sec. 1147 of the Reform Act, and sec. 7701(j) of the Code)

Present Law

Beginning in 1987, an employee generally is permitted to contribute up to 10 percent of the employee's rate of basic pay to the Thrift Savings Plan maintained by the Federal Government. If special nondiscrimination requirements are satisfied and the limitation on elective deferrals is not exceeded, contributions to the plan are not treated as made available merely because the employee had an election to receive the amounts in cash. Therefore, the amounts deferred are not includible in an employee's income until distributed.

Explanation of Provision

The bill clarifies that the Thrift Savings Plan is required to meet the rules of section 401(k)(4)(B) under which the Plan may not be maintained by any State or local government or any tax-exempt organization.

In addition, under the bill, the Thrift Savings Fund may elect to have the nondiscrimination requirements applied separately to contributions to the Fund with respect to employees who are covered by the Civil Service Retirement and Disability System (CSRS) and thus are treated differently under the Thrift Savings Plan (e.g., with respect to matching contributions). Separate treatment under the nondiscrimination rules is analogous to the rules applicable to qualified plans maintained by employers other than the Federal Government.

4. Effective dates for collectively bargained plans (secs. 6671(c), (g), (h), and (n), and 6671A(e) of the bill, and secs. 1105, 1111, 1112, 1120, and 1131 of the Reform Act)

Present Law

Under the Act, the effective dates of certain provisions are delayed with respect to plans maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before March 1, 1986 ("collectively bargained plans"). In some cases, the delayed effective date applies to the entire plan and, in other cases, the delay only applies to, for example, individuals covered by 1 or more of the collective bargaining agreements.

The provisions subject to the delayed effective date generally do not apply to years beginning before the earlier of—

(1) the later of (a) January 1, 1989 (or, in certain cases, January 1, 1987) or (b) the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986), or

(2) January 1, 1991, (or, in certain cases, January 1, 1989).

Explanation of Provision

The bill generally provides that the delayed effective date with respect to collectively bargained plans applies to the entire plan in the case of the amendments made by sections 1111 (relating to the application of nondiscrimination rules to integrated plans) and 1112 (relating to the minimum coverage and participation requirements for qualified plans) of the Act. As under present law, this delayed effective date does not apply to any noncollectively bargained plans even if such plans have terms identical to those of a collectively bargained plans.

Also, the bill modifies the delayed effective date with respect to the amendments made by section 1105, relating to the $7,000 limit on elective deferrals. Under present law, the $7,000 limit does not apply to contributions under a collectively bargained plan made pursuant to 1 or more of the collective bargaining agreements relating to the plan for taxable years beginning before the earlier of—

(1) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986), or

(2) January 1, 1991.

Under the bill, clause "(1)" above is modified to refer to the date on which the collective bargaining agreement pursuant to which the contribution is being made terminates. This change is appropriate because the $7,000 limit is applied at the individual taxpayer level. Thus, the later termination of a collective bargaining agreement to which an individual is not subject should not affect that individual's tax treatment.

The bill also provides a delayed effective date for collectively bargained plans with respect to 2 additional sections of the Act. First, the amendments made by section 1120, applying nondiscrimination rules to tax-sheltered annuity programs (sec. 403(b)), are not to apply to collectively bargained plans in plan years beginning before the earlier of—

(1) the later of (a) January 1, 1989, or (b) the date on which the last of the collective bargaining agreements terminates (without regard to any extension thereof after February 28, 1986), or

(2) January 1, 1991.

This delayed effective date applies to the entire program.

In addition, the amendments made by section 1131, relating to the limits on deductions for contributions under a qualified plan and to the excise tax on nondeductible contributions under a qualified plan, are not to apply to contributions under a collectively bargained plan made pursuant to any of the collective bargaining agreements relating to the plan for taxable years beginning before the earlier of—

(1) January 1, 1989, or

(2) the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986).

5. Deferred annuity contracts (sec. 6671A(i) of the bill, sec. 1135 of the Reform Act, and sec. 72(u) of the Code)

Present Law

Under present law, if any annuity contract is held by a person who is not a natural person (such as a corporation), then the contract is not treated as an annuity contract for Federal income tax purposes and the income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year.

This rule does not apply to certain annuity contracts, including an immediate annuity contract, which is an annuity (1) that is purchased with a single premium or consideration, and (2) the annuity starting date of which commences no later than 1 year from the date of purchase of the annuity.

Explanation of Provision

The bill modifies the definition of an immediate annuity contract to prevent the structuring of a contract so that it appears to be an immediate annuity contract, but that is in substance as deferred annuity. Accordingly, the bill provides that an annuity is an immediate annuity only if the annuity provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period. An annuity will not be treated as failing to satisfy this requirement if it an annuity payable over the joint lives of two or more individuals and the amounts paid to a survivor after the death of the first annuitant are less than the amounts paid during the life of the first annuitant.

F. Employee Benefit Provisions

1. Nondiscrimination rules for statutory employee benefit plans (sec. 6671B(a) of the bill, sec. 1151 of the Reform Act, sec. 209 of the Social Security Act, and secs. 89, 125, 129, 414, 3231, 3306, 3401, and 6652 of the Code)

In general

Under present law, new nondiscrimination rules apply to statutory employee benefit plans (sec. 89). The term "statutory employee benefit plans" includes accident or health plans and group-term life insurance plans. At the election of the employer, the term also includes qualified group legal services plans, educational assistance programs, and dependent care assistance programs.

Under the new nondiscrimination rules, a plan generally is required to satisfy 3 eligibility tests—a 50-percent test, a 90-percent/50-percent test, and a nondiscriminatory provision test—and a benefits test. Alternatively, a plan may satisfy an 80-percent coverage test, provided its also satisfies the nondiscriminatory provision test.

Nondiscrimination tests

50-percent test

Under the 50-percent test, nonhighly compensated employees must constitute at least 50 percent of the group of employees eligible to participate in the plan. This requirement will be deemed satisfied if the percentage of highly compensated employees who are eligible to participate is not greater than the percentage of nonhighly compensated employees who are eligible.

90-percent/50-percent test

A plan does not satisfy the 90-percent/50-percent test unless at least 90 percent of the employer's nonhighly compensated employees are eligible for a benefit that is at least 50 percent as valuable as the benefit available to the highly compensated employee to whom the most valuable benefit is available. For purposes of this test, all plans of the same type (i.e., all benefits excludable under the same Code section) are aggregated.

For purposes of this 90-percent/50-percent test, available salary reduction is not taken into account.

Nondiscriminatory provision test

The third eligibility test provides that a plan may not contain any provision relating to eligibility to participate that by its terms or otherwise discriminates in favor of highly compensated employees. This third test is intended to disqualify arrangements only on the basis of discrimination that is not quantifiable.

Benefits test

A plan does not satisfy the benefits test unless the average employer-provided benefit received by nonhighly compensated employees under all plans of the employer of the same type (i.e., plans providing benefits excludable under the same Code section) is at least 75 percent of the average employer-provided benefit received by highly compensated employees under all plans of the employer of the same type.

Alternative test

Present law also provides an alternative test that may be applied in lieu of the eligibility and benefits tests described above. If a plan benefits at least 80 percent of an employer's nonhighly compensated employees, such plan is considered to satisfy the new nondiscrimination rules. This alternative test will not apply unless the plan satisfies the nondiscriminatory provision test described above.

This alternative test applies only to accident or health plans and group-term life insurance plans. For purposes of this alternative test, an individual will only be considered to benefit under a plan if such individual receives coverage under the plan; eligibility to receive coverage is not considered benefiting under the plan.

Valuation

The Secretary is to prescribe rules regarding valuation of different benefits. With respect to health coverage, the Secretary is to establish tables prescribing the relative values of different types of health coverage.

Definitions

For purposes of applying the new nondiscrimination rules, present law provides generally applicable definitions of the following: (1) highly compensated employee (sec. 414(q)); (2) employer (including the employee leasing rules (sec. 414 (b), (c), (m), (n), (o), and (t))); (3) line of business or operating unit (as present law permits the new nondiscrimination rules to be applied separately to separate lines of business or operating units (sec. 414(r))); and (4) employees who are excluded from consideration. These definitions, other than the line of business or operating unit rule, apply generally to all employee benefit plans, not only to statutory employee benefit plans.

Qualification and reporting requirements

Employee benefit plans generally are subject to new qualification and reporting requirements (sec. 89(k) and (1)).

a. Employers with no nonhighly compensated employees

Present Law

Under present law, the nondiscrimination rules applicable to statutory employee benefit plans are applied to reference to the eligibility of nonhighly compensated employees to participate in a plan or to the amount of benefits provided to nonhighly compensated employees under a pian. It is unclear under present law how these nondiscrimination rules apply in the case of an employer who has no nonhighly compensated employees.

Explanation of Provision

The bill clarifies that the nondiscrimination rules do not apply to an employer in a year in which such employer has no nonhighly compensated employees. As is so with respect to the nondiscrimination rules generally, this rule is to apply separately with respect to former employees under rules prescribed by the Secretary.

b. Plan aggregation—accident or health plans

Present Law

Under present law, each different option generally is a separate plan for testing purposes. However, for purposes of the 50-percent eligibility test and the alternative 80-percent test, comparable accident or health plans may be aggregated (sec. 89(g)(1)).

Explanation of Provision

The bill provides that, under rules prescribed by the Secretary, if an employee is eligible for (in the case of the 50-percent test) or receives coverage under more than 1 accident or health plan, then, for purposes of the 50-percent test and the alternative 80-percent test, such plans are required to be considered 1 plan with respect to such employee.

For example, assume that an employer maintains 2 plans: 1 benefiting all employees with a value of $950 and a second benefiting only highly compensated employees with a value of $1,000. The highly compensated employees receiving benefits from both plans are to be treated for purposes of the 50-percent test and the alternative 80-percent test as receiving $1,950 of benefits from 1 plan while the nonhighly compensated employees are to be treated as receiving $950 of benefits from a separate plan. Under the comparability rules (sec. 89(g)(1)), these plans would not be comparable so that the plan covering the highly compensated employees would satisfy neither the 50-percent test nor the alternative 80-percent test.

This rule, requiring certain plans to be treated as 1 plan with respect to certain employees, supersedes the rule of present law allowing employers to structure options in different ways as long as all coverage within a plan is identical.

c. Plan definition—group-term life insurance

Present Law

Under present law, each different option generally is a separate plan for testing purposes. This means, for example, that if 2 types of insurance coverage vary in any way (including the amount of required employer contributions), they will be considered separate plans.

Explanation of Provision

The committee intends that there be an additional exception to the general rule that if 2 types of insurance coverage vary in any way, they will be considered separate plans. Pursuant to this exception, under rules prescribed by the Secretary, if with respect to group-term life insurance coverage, the required employee contributions vary according to the age of the employee, this variation will not preclude treatment of the coverage as a single plan. Thus, for example, if an employer offers every employee group-term life insurance coverage equal to one times compensation, provided that the employee contribute one quarter of the cost of such coverage, this will constitute a single plan even if the cost of each employee's coverage is determined on the basis of such employee's age. (Present law allows group-term life insurance that varies in proportion to compensation to be considered a single plan.)

If an employer uses the special rule described above, an employee-purchased coverage is not treated as employer-provided, then the amount of employer-provided group-term life insurance coverage with respect to any employee is the amount that bears the same relationship to the total coverage for such employee as the employer's contribution (determined on an age-rated basis) bears to the age-rated cost of such employee's total coverage. For example, if an employee contributes one quarter of the age-rated cost of $100,000 of coverage, and employee-purchased coverage is not treated as employer-provided, the employer-provided group-term life insurance coverage with respect to such employee is $75,000.

If the employer does not use the the special rule described above, an employee-purchased coverage is not treated as employer-provided, the amount of employer-provided group-term life insurance coverage with respect to any employee is determined in the same manner except that the total cost of any employee's coverage and the employer's contributions with respect to such coverage are to be determined without regard to the employee's age.

If an employer uses the special rule described above with respect to any group-term life insurance, then the employer is required to use the special rule with respect to all group-term life insurance coverage of the employer. Thus, with respect to such an employer, coverage available for a required contribution that does not vary according to age would not be considered a single plan. Of course, this rule applies separately to any line of business or operating unit if the employer applies the rules of section 89 separately to such line of business or operating unit pursuant to section 89(g)(5).

d. Family coverage

Present Law

Under present law, a special rule applies in the case of family coverage under an accident or health plan. Pursuant to this special rule, for purposes of the 90-percent/50-percent test, the coverage for employees and the coverage for spouses and dependents may be tested separately, as if they constituted 2 different types of plans. Further, for purposes of the same test, with respect to coverage of spouses and dependents, the employer may disregard employees who do not have a spouse or dependent. An employer who elects this latter optional rule is required to obtain and maintain, in such manner as the Secretary prescribes, adequate sworn statements to demonstrate whether employees have a spouse or dependent.

Explanation of Provision

The bill deletes the rule allowing employers to apply the 90-percent/50-percent test separately with respect to family coverage and to take into account for such purpose only employees who have a family. This rule implies that family coverage cannot be considered available to an employee who does not have a family.

Under the bill, family coverage (i.e., coverage of an employee's family which is considered separate from coverage of the empoyee) may be considered to be available (if otherwise available) or provided (if otherwise provided) to an employee despite the fact that the employee does not have a family. The purpose of this rule is to relieve employers from the burden of determining which employees have families.

This rule alone, however, could produce inappropriate results in certain very limited circumstances and it is intended that the nondiscriminatory provision test be applied to prevent such results. Thus, if, under the facts and circumstances, it is clear that the employer is, by using the above rule that allows family coverage to be considered to be available or provided to an employee who does not have a family, evading the other nondiscrimination tests, the nondiscriminatory provision test is not to be considered satisfied with respect to the relevant plan or plans.

For example, assume that an employer had 2 highly compensated employees and 8 nonhighly compensated employees, none of whom had families. The employer provided $3,000 of employee coverage to each of the 2 highly compensated employees. For the same year, the employer provided family coverage to each of the 8 nonhighly compensated employees the value of which was $3,000 per employee under the Secretary's valuation tables. Because comparable plans may be aggregated for purposes of the alternative 80-percent test, the employer would satisfy such test. This is not the result intended by Congress, since the facts of this example clearly indicate that by using the rule allowing family coverage to be considered to be provided to employees without families, the employer is avoiding providing the nonhighly compensated employees truly nondiscriminatory benefits. Thus, the nondiscriminatory provision test would not be considered satisfied with respect to the plan covering the highly compensated employees.

This application of the nondiscriminatory provision test applies not only with respect to evasion of the alternative 80-percent test, but to evasion of any of the tests. For example, the nondiscriminatory provision test would not be considered satisfied with respect to a plan maintained by the employer in the above example for its highly compensated employees if such plan satisfied the 90-percent/50-percent test by virtue of a second plan making family coverage available to the nonhighly compensated employees.

e. Sworn statements—benefits test

Present Law

For purposes of applying the benefits test to accident or health plans, an employer generally (see sec. 89(g)(2)(D)) may elect to disregard any employee or family member of an employee if such individual is covered by a health plan that provides core benefits and that is maintained by another employer of the employee or of a member of the employee's family. An employer who elects this optional rule is required to obtain and maintain, in such manner as the Secretary prescribes, adequate sworn statements to demonstrate whether individuals have core health coverage from another employer.

Explanation of Provision

The bill provides that, with respect to an employer ("first employer"), an individual may be considered to have core health benefits from another employer of such individual or of a member of such individual's family, despite the fact that no sworn statement is obtained and maintained to that effect, if (1) the first employer makes available to an employee, at no cost, core health benefits with respect to such individual, and (2) no health benefits under any plan of the first employer are provided with respect to such individual. For purposes of this rule, any financial detriment with respect to core health benefits, regardless of whether it is direct or indirect, current or future, fixed or contingent, is considered a cost rendering this special rule inapplicable. A benefit that is available to an employee on the condition that such employee reduce his salary or forego another benefit is considered available at a cost.

Under present law, with respect to an employer that elects to disregard individuals covered (or deemed covered under the rule described above) by another employer's core health benefits, in the absence of a sworn statement, a highly compensated employee is treated as (1) covered by a plan of another employer providing core health benefits, and (2) not having a spouse or dependent. Thus, the special rule under the bill described above only affects non-highly compensated employees.

f. Sworn statements—80-percent test

Present Law

For purposes of applying the benefits test and the alternative 80-percent test to accident or health plans, the coverage for employees and the coverage for spouses and dependents may be tested separately, as if they constituted 2 different types of plans. For purposes of the same tests, with respect to separate testing of the coverage of spouses and dependents, the employer may disregard employees who do not have a spouse or dependent. An employer who elects this latter optional rule is required to obtain and maintain, in such manner as the Secretary prescribes, adequate sworn statements to demonstrate whether employees have a spouse or dependent.

With respect to an employer electing the latter special rule decribed above, in the absence of a sworn statement, a highly compensated employee is treated as, *inter alia,* not having a spouse or dependent. If an employee is treated as not having a spouse or dependent, any coverage provided to any spouse or dependent of that employee generally is disregarded. For purposes of applying the benefits test, however, the family of a highly compensated employee may not be disregarded nor may coverage provided to such family be disregarded if the coverage provided with respect to such family has a value in excess of 133⅓ percent of the average employer-provided benefit provided with respect to families of nonhighly compensated employees.

Explanation of Provision

Under the bill, a rule similar to the special "133⅓-percent rule" applies for purposes of the alternative 80-percent test.

For purposes of the 80-percent test, the general rule is that a group of plans are comparable and may be aggregated if the value of the employer-provided coverage provided to each covered employee in the plan with the lowest such value is at least 95 percent of the value of the employer-provided coverage provided to each covered employee in the plan with the highest such value. However, if a plan with a greater value than permitted under the previous sentence satisfies section 89(d)(2) based on actual coverage provided rather than on eligibility, such plan may be aggregated with the group of less valuable plans for purposes of the 80-percent test.

Under the analogue to the 133⅓-percent rule, for purposes of the 80-percent test, the family of a highly compensated employee may not be disregarded nor may coverage provided to such family be disregarded if the coverage provided to any spouse and dependents of such employee is provided under a plan that would need to rely on the section 89(d)(2) test to be aggregated with a group of plans satisfying the 80-percent test. Of course, under the 80-percent test, if no group of plans satisfies the 80-percent test, no coverage provided to family members of highly compensated employees may be disregarded.

g. Excluded employees

Present Law

Under present law, certain classes of employees are disregarded in applying the nondiscrimination rules if neither the plan, nor any other plan of the same type, is available to any employee in the same class. Two of the disregarded classes are (1) in the case of an accident or health plan (other than with respect to noncore benefits), employees who have not completed 6 months of service (or such shorter period of service as may be specified in the plan); and (2) in the case of any other statutory employee benefit plan (including an accident or health plan with respect to noncore benefits), employees who have not completed 1 year of service (or such shorter period of service as may be specified in the plan).

An employer is to exclude an employee, on the grounds that such employee has not satisfied the required period of initial service, during the period prior to the first day of the calendar month immediately following the actual satisfaction of the initial service requirement. In general, this exclusion does not apply if any employee is eligible under any plan of the same type prior to the first day of the calendar month immediately following the actual satisfaction of the initial service requirement.

In addition, the legislative history of the Act provided certain rules of convenience, relating to the time at which the nondiscrimination rules are to be applied, that were intended to reduce the administrative burden of applying the nondiscrimination rules.

Explanation of Provision

Under the bill, the rule regarding the exclusion of employees between the date of actual satisfaction of the initial service requirement and the first day of the calendar month immediately following such satisfaction is modified so that an employer may use, instead of the first day of the next calendar month, the first day of a period of less than 31 days specified by the plan. For example, assume that an employer required 60 days of service for participation in a health plan, but did not allow participation to commence other than on the first day of 4-week periods. Such employer is to exclude employees during the period prior to the first day of the 4-week period following satisfaction of the 60-days-of-service requirement.

The Secretary is to provide corresponding changes to the rules of convenience relating to the time for testing described in the legislative history of the Act.

This amendment, allowing use of a period of less than 31 days, provides employers with flexibility without adversely affecting the policy of the nondiscrimination rules.

h. Self-employed individuals

Present Law

Under the Act, it is unclear whether self-employed individuals are treated as employees for purposes of the nondiscrimination rules applicable to statutory employee benefit plans.

Explanation of Provision

The bill clarifies that, for purposes of applying the nondiscrimination rules to statutory employee benefit plans, the term "employee" includes any self-employed individual (as defined in sec. 401(c)(1)), and the term "compensation" includes such individual's earned income (as defined in sec. 401(c)(2)).

In addition, an individual who owns the entire interest in an unincorporated trade or business is to be treated as his or her own employer. A partnership is to be treated as the employer of each partner who is treated as an employee under the rule described above.

These rules do not affect whether a self-employed individual may exclude a benefit provided under a statutory employee benefit plan. For example, group-term life insurance provided to a self-employed individual may not be excluded by the self-employed individual because section 79 does not apply to self-employed individuals. The effect of this provision of the bill is to count a self-employed individual as an employee even though such individual is not eligible for the exclusion. Generally, this will facilitate compliance with the nondiscrimination rules, since self-employed individuals, who generally are highly compensated employees under the applicable definition (sec. 414(q)), are taken into account but treated only as eligible for and receiving benefits that are excludable or deductible. Thus, for example, with respect to health benefits, a self-employed individual is treated as receiving (or eligible for) a benefit equal to 25 percent of the amount paid (or payable) for health insurance, since that is the only amount that is tax-favored with respect to a self-employed individual (secs. 106 and 162(m)).

i. Qualification rule

Present Law

Under present law, certain employee benefit plans, including accident or health plans, are subject to certain qualification rules (sec. 89(k)). For example, the plan is required to be in writing.

Explanation of Provision

The committee clarifies that standard short-term sick pay plans were not intended to be subject to the qualification rules of section 89(k). Thus, under rules prescribed by the Secretary, such plans are to be exempted from the qualification rules. It is anticipated that the rules prescribed by the Secretary will identify standard short-term sick pay plans by reference to the length of time the employer will provide benefits while an individual is absent from work.

j. Sanctions

Present Law

Year of inclusion

Under present law, if a plan is discriminatory in a plan year, highly compensated employees are taxable on the value of the discriminatory excess in their taxable year in which or with which the plan year ends.

Discriminatory excess

The discriminatory excess is defined as the amount of the otherwise nontaxable employer-provided benefit (including benefits purchased with elective contributions) that would have to have been purchased with after-tax employee contributions by the highly compensated employees in order for all of the nondiscrimination tests to be satisfied. In the case of group-term life insurance, the value of discriminatory coverage is the greater of the cost of coverage under section 79(c) or the actual cost of coverage.

Of course, as is generally the case, the taxpayer has the burden of proof with respect to establishing the discriminatory excess. Thus, the discriminatory excess includes all employer-provided benefits for highly compensated employees except to the extent that the taxpayer maintains sufficient records to demonstrate to the Internal Revenue Service that such benefits do not constitute discriminatory excess.

Qualification rule sanction

If a plan fails to satisfy the new qualification requirements (sec. 89(k)), employees covered under the plan generally are to include in gross income the employer-provided benefit under the plan. For this purpose, even in the case of an insurance-type plan, an employee's employer-provided benefit is the value of the benefits, not the coverage, attributable to employer contributions.

Employer sanction

If the employer does not report the discriminatory excess (or other amounts includible under sec. 89) in a timely manner, the employer may be subject to an employer-level sanction (sec. 6652(l)). This sanction applies without regard to whether the relevant benefit was automatically subject to section 89 or whether it was only subject to section 89 due to an election by the employer under section 89(i)(2).

Welfare benefit funds

In general, if a voluntary employees' beneficiary association (VEBA) (sec. 501(c)(9)) or group legal services organization (GLSO) (sec. 501(c)(20)) is part of a discriminatory plan, the VEBA or GLSO is not to be exempt from tax under section 501(a) (sec. 505). With respect to employee benefits subject to the new nondiscrimination rules of section 89, a discriminatory plan for this purpose is a discriminatory employee benefit plan within the meaning of section 89(c).

In addition, if an employer maintains a welfare benefit fund and there is a disqualified benefit provided during any taxable year, a tax is imposed on the employer equal to 100 percent of the disqualified benefit. The term "disqualified benefit" includes any post-retirement medical benefit or life insurance benefit provided with respect to a highly compensated employee under a discriminatory plan (within the meaning of sec. 505).

Explanation of Provision

Year of inclusion

Under present law, if a plan is discriminatory and the plan year is, for example, the calendar year, the employer has only 1 month to determine the discriminatory excess with respect to the highly compensated employees in order to file accurate Forms W-2 in a timely manner. In many cases, this is not a sufficient period of time. Thus, the bill provides a special rule with respect to plans with a plan year ending after September 30 and on or before December 31 of a calendar year.

Under this special rule, an employer may elect to have the discriminatory excess included in the incomes of highly compensated employees in their taxable year following the taxable year with or within which the plan year ends. If an employer makes such an election, however, the employer's deduction relating to such discriminatory excess is to be allowable only in the employer's taxable year with or within which ends the plan year following the plan year in which the discriminatory excess occurred. It is not intended, however, that an employer be permitted to avoid the deferral of the deduction through the use of a short plan year following the plan year in which the discriminatory excess occurred.

Discriminatory excess

For purposes of determining and allocating the discriminatory excess with respect to a group-term life insurance plan, employer-provided coverage over $50,000 will be treated as nontaxable under the bill. Thus, to the extent that the discriminatory coverage does not exceed the total coverage over $50,000, the effect of a finding of discrimination is simply the inclusion in income of the excess, if any, of the actual cost of the discriminatory coverage over the cost of such coverage under section 79(c).

For example, assume an employee receives $150,000 of employer-provided coverage and the $100,000 excess over $50,000 is included in income, at the cost determined under section 79(c), pursuant to section 79(a). Assume further that $25,000 of such employee's coverage is determined to be discriminatory. The effect of this finding of discrimination is that the excess, if any, of the actual cost of such $25,000 of coverage over the section 79(c) cost of such coverage is included in the employee's income (in addition to the section 79(c) cost of the $100,000 of coverage (i.e., the amount over $50,000)).

Qualification rule sanction

If a plan to which section 505 applies—generally, a plan part of which is a VEBA or a GLSO—violates the new qualification requirements (sec. 89(k)), the VEBA or GLSO is not to be exempt from tax under section 501(a). A plan failing to satisfy the new qualification requirements is not the type of plan for which the VEBA or GLSO tax exemption was established.

In addition, the bill provides that in the case of a group-term life insurance plan that fails the qualification rule, the benefits provided under the plan are to be included in the beneficiary's income rather than the employee's.

The bill further provides for the coordination of the sanction for failure to satisfy the qualification rules with the sanction for discrimination. Generally, any amount included in the income of a highly compensated employee attributable to discriminatory coverage is to offset the amount includible under section 89(k) with respect to the same highly compensated employee for the same coverage. Thus, for example, assume a highly compensated employee includes $100 in income under section 89(a) for discriminatory health coverage provided during a plan year, and such health coverage does not satisfy section 89(k). The only health benefits that are includible under section 89(k) attributable to the coverage provided during that plan year are amounts in excess of $100.

If, however, any discriminatory excess would be included in the income of a highly compensated employee for a year subsequent to the year of inclusion under section 89(k) with respect to the same coverage, the coordination described above is to work in reverse, i.e., the section 89(k) inclusion is to offset the inclusion of the discriminatory excess.

Employer sanction

If an employer does not report a discriminatory excess (or other amount includible under sec. 89) in a timely manner, the employer may be subject to an employer-level sanction. Under the bill, it is clarified that the employer-provided benefit subject to the employer sanction is determined under the general rules applicable under section 89 except that the special rule relating to group-term life insurance plans, under which employees are assumed to be age 40, does not apply. Of couse, the adjustment of the employer-provided benefit under a group-term life insurance plan based on the employee's compensation also does not apply.

Welfare benefit funds

The committee believes that the sanctions of present law with respect to discriminatory VEBA's GLSO's and other welfare benefit funds are inconsistent with the general approach under section 89 to apply the sanction solely with respect to the discriminatory amount. The bill modifies the sanctions accordingly.

Under the bill, if section 89 applies to a plan, a VEBA or GLSO that is part of the plan does not lose its tax-exempt status under section 501(a) merely because the plan is a discriminatory employee benefit plan (within the meaning of sec. 89(c)). In lieu of this sanction, the bill imposes an excise tax on an employer maintaining a welfare benefit fund is a discriminatory employee benefit plan is part of the fund for the plan year. The tax applies to the taxable year of the employer with or within which the plan year ends.

The amount of this excise tax is determined as follows. The first step is to determine the lesser of (1) the aggregate excess benefits (within the meaning of sec. 89(b)) provided under the plan for the plan year, or (2) the taxable income of the fund for the plan year. For this purpose, the taxable income of the fund is determined without regard to an exemption from tax pursuant to section 501(c)(9) or (c)(20). The lesser of those 2 amounts is then multiplied by the highest rate applicable to taxable income under section 11. This product then is offset by the amount of income tax imposed on the fund for the plan year determined under rules prescribed by the Secretary. This result is the amount of the excise tax.

The bill also modifies the 100-percent excise tax applicable to disqualified benefits in the case of a post-retirement medical benefit of life insurance benefit that is subject to section 89. The bill provides that the amount of the disqualified benefit subject to the tax is not to exceed the aggregate excess benefits (within the meaning of sec. 89(b)) provided under the plan.

k. Inclusion in wages

Present Law

Under present law, amounts that are includible in an employee's income because the section 89 requirements relating to employee benefit plans are not satisfied are not in all cases treated as wages (or compensation) for employment tax purposes.

Explanation of Provision

Under the bill, amounts that are includible in gross income by reasons of section 89 (either directly or indirectly (as in the case of section 129(b)(1)(B))) are included in wages (or compensation), as of the time includible in gross income, for purposes of the Railroad Retirement Tax Act (sec. 3231(e)), the Federal Unemployment Tax Act (sec 3306), and income tax withholding (sec. 3401). Of course, such inclusion is subject to the applicable limits on wages (or compensation).

1. Dependent care assistance programs

Present Law

Present law provides a benefits test applicable to dependent care assistance programs that are not treated as statutory employee benefit plans under section 89 (sec. 129(d)(8)). For purposes of applying this benefits test to salary reduction amounts, employees with compensation (as defined in sec. 414(q)(7)) below $25,000 are to be disregarded. This special rule does not apply if the dependent care assistance program is treated as a statutory employee benefit plan under section 89.

Explanation of Provision

For purposes of applying the special benefits test (sec. 1,29(d)(7), as redesignated by the bill) to salary reduction amounts under a dependent care assistance progam that is not treated as a statutory employee benefit plan under section 89, an employer may elect to take into account employees with compensation (as defined in sec. 414(q)(7)) below $25,000. Thus, the employer may elect to take into account all employees with compensation below $25,000 or may disregard employees with compensation below any specified amount lower than $25,000.

m. Cafeteria plans

Present Law

Definition of a cafeteria plan

Under present law, the definition of a cafeteria plan includes a plan only offering a choice between nontaxable benefits (sec. 125).

Qualified benefits

To qualify as a cafeteria plan, a plan may not offer benefits other than cash and qualified benefits. The term "qualified benefits" generally means any benefit that, with the application of section 125(a), is excludable from an employee's income by reason of a provision of Chapter 1 of the Code (other than secs. 117, 124, 127, or 132). In addition, the term includes (1) any group-term life insurance coverage that is includible in income only because it is in excess of $50,000, and (2) any other benefit permitted under regulations.

Explanation of Provision

Definition of a cafeteria plan

The bill amends the definition of a cafeteria plan so that a choice only between nontaxable benefits is not a cafeteria plan. The inclusion of a choice between nontaxable benefits as a cafeteria plan would require, to make the provision effective as a practical matter, additional amendments not intended by Congress. For example, under present law, a choice between nontaxable benefits, one of which constituted deferred compensation, would generally not be a cafeteria plan in light of the prohibition on deferred compensation in a cafeteria plan. Thus, an employer could simply add to any choice between nontaxable current benefits the choice of a nominal nontaxable deferred benefit; this would at least arguably remove the arrangement from the definition of a cafeteria plan. Although this and other problems with the new definition could have been individually addressed with additional rules, such rules would have added complexity not contemplated by Congress.

Sanctions

The bill also clarifies that, in the case of a cafeteria plan that fails the cafeteria plan nondiscrimination test (sec. 125(b)(1)), only highly compensated employees are taxable on the available taxable benefits. In the case of a cafeteria plan that fails the key employee concentration test (sec. 125(b)(2)), the bill clarifies that only key employees are taxable on the available taxable benefits.

Qualified benefits

In addition, the bill modifies the definition of qualified benefits. Under the bill, the term "qualified benefits" includes benefits that would be qualified benefits but for the fact that they are includible in an employee's income under section 89(a). Thus, if, for example, there is a discriminatory excess with respect to a health plan offered under a cafeteria plan, such discriminatory excess will not cause the cafeteria plan to cease to be a cafeteria plan.

The bill also modifies the special definition of qualified benefits used for purposes of determining whether under the key employee concentration test (sec. 125(b)(2)), the qualified benefits provided to key employees under a cafeteria plan exceed 25 percent of the aggregate of such benefits provided to all employees under the plan. For this purpose, benefits that are includible in income (without regard to the key employee concentration test of sec. 125(b)(2)) are disregarded.

n. Continuation of health care

Present Law

Under present law, for purposes of most employee benefit provisions, certain aggregation rules are applies (sec. 414(b), (c), (m), (o), and (t)). Thus, related employers generally are treated as a single employer for purposes of these provisions. Further, under certain circumstances, leased employees may be treated as employees of the lessee (sec. 414(n)).

Explanation of Provision

The bill extends the rules aggregating related employers (sec. 414(b), (c), (m), (o), and (t)) and the employee leasing rules (sec. 414(n)) to the continuation-of-health-care rules under section 162(i)(2) and 162(k) and under section 2201(b) of the Public Health Service Act. (The Act applied such aggregation and leasing rules for purposes of the continuation-of-health-care rules under sec. 106 and the Employment Retirement Income Security Act of 1974 (ERISA).) Such extension presents evasion of the continuation-of-health-care rules by the use of multiple employers, employee leasing, or other arrangements.

Under the bill, this extension and the application under the Act of the same aggregation and leasing rules to section 106 (relating to the exclusion from income of employer-provided accident or health coverage) and to the continuation-of-health-care rules of ERISA are effective for years beginning after 1986.

o. Effective date

Present Law

In general, the amendments made by section 1151 of the Act, which provide the new rules regarding nondiscrimination, dependent care assistance programs, cafeteria plans, qualification, and reporting generally are effective for years beginning after the later of—

(1) December 31, 1987, or
(2) the earlier of—
  (a) the date that is 3 months after the date on which the Secretary issues regulations under section 89, or
  (b) December 312, 1988.

Explanation of Provision

Under the bill, an employer may elect to apply the new rules of section 1151 of the Act (including the nondiscrimination rules, qualification rules, reporting rules, and cafeteria plan rules) to certain group-term life insurance plans in plan years beginning after October 22, 1986. The plans for which this election is available are described in section 125(c)(2)(C).

2. Exclusion of cafeteria plan elective contributions from wages for purposes of employment taxes (sec. 6671B(a) of the bill, sec. 1151(d) of the Reform Act, and sec. 3306(b)(5) of the Code)

Present Law

Under present law, no amount is included in the gross income of a participant in a cafeteria plan meeting certain requirements solely because, under the plan, the participant may choose among the benefits of the plan. Under the Act, this exception from the principles of constructive receipt generally also applies for purposes of FICA and FUTA taxes. The exception does not apply, however, for FICA and FUTA tax purposes with respect to elective deferrals under a qualified cash or deferred arrangement that is part of a cafeteria plan.

Explanation of Provision

The bill clarifies that the exclusion from wages provided under the Act with respect to FUTA taxes applies to payments and benefits under a cafeteria plan if (1) it is reasonable to believe that (if sec. 125 applied for purposes of FUTA taxes) section 125 would not treat any wages as constructively received, and (2) the payments would not be treated as wages if provided outside of the cafeteria plan. As is the case for income tax purposes, the failure of a cafeteria plan to satisfy the discrimination test does not cause inclusion with respect to nonhighly compensated employees and the failure of a cafeteria plan to satisfy the key employee concentration test does not cause inclusion with respect to nonkey employees.

For example, no amount is included in any employee's wages for FUTA tax purposes attributable to the employee's election under a cafeteria plan that satisfies the applicable discrimination test and key employee concentration test of a health benefit that is otherwise excludable from wages. Of course, a collectively bargained plan that is deemed to be nondiscriminatory for income tax purposes (sec. 125(f)) is deemed to meet the cafeteria-plan discrimination test (sec. 125(b)(1)) for purposes of this rule.

3. Military fringe benefits (sec. 6671B(b) of the bill, sec. 1168 of the Reform Act, and sec. 134 of the Code)

Present Law

Under present law, qualified military benefits are excludable from gross income. The term "qualified military benefit" generally means any allowance or in-kind benefit that—

> (1) is received by any member of former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services, and
>
> (2) was excludable from gross income on September 9, 1986, under any provision of law or regulation thereunder that was in effect on such date (other than a provision of Title 26).

For purposes of the exclusion of qualified military benefits that are payable in cash, certain adjustments to such benefits after September 9, 1986, are to be disregarded and thus are not to be covered by the section 134 exclusion.

Of course, benefits provided in connection with an individual's status or service as a member of the uniformed services may be excluded from income under other sections of the Code if the requirements for exclusion under such other sections are satisfied, even if such benefit does not qualify as a qualified military benefit.

Explanation of Provision

The bill clarifies that, with respect to the definition of qualified military benefit, the exclusion on September 9, 1986, may have been by administrative practice, in addition to by law or regulation.

The bill also provides that the term "qualified military benefit" does not include personal use of a vehicle. This amendment applies to taxable years beginning after December 31, 1986.

Under the bill, it is further intended that qualified military benefits that are provided in kind may be modified or adjusted after September 9, 1986, without affecting the excludability of such benefit under section 134.

In addition, the bill modifies the general effective date of section 134 to apply to taxable years beginning after December 31, 1984 (rather than beginning after December 31, 1986).

G. Employee Stock Ownership Plans (ESOPs); ESOP Estate Tax Deduction

An employee stock ownership plan (ESOP) is a qualified stock bonus plan or a combination of a stock bonus and a money purchase pension plan under which employer stock is held for the benefit of employees. The stock, which is held by 1 or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts) that is exempt under section 4975. An ESOP is required to be designed to be invested primarily in employer securities.

1. Changes in qualification requirements relating to ESOPs (sec. 6671B (i), (j), and (k) of the bill, secs. 1174-1176 and 1854 of the Reform Act, and secs. 401, 415, and 409 of the Code)

a. Diversification of investments

Present Law

The Act requires an ESOP to offer a partial diversification election to participants who meet certain age and participation requirements (qualified participants). Under the Act, a qualified participant is entitled annually during any diversification election period following each plan year in the participant's qualified election period to direct diversification of up to 25 percent of the participant's account balance (50 percent in the last election period).

Under the Act, an ESOP is required to provide an annual diversification election period for the 90-day period following the close of the ESOP plan year. Thus, for 90 days after the end of a plan year, an ESOP is to permit an election by those qualified participants who become or remain eligible to make a diversification election during the plan year. Under the Act, any participant who has attained at least age 55 and completed at least 10 years of participation in the plan is a qualified participant. For purposes of the 10-year of participation rule, participation in a predecessor plan is taken into account.

A qualified participant may modify, revoke, or make a new election at any time during the 90-day election period. Any qualified participant is permitted to make a diversification election during each diversification election period following each plan year in the participant's qualified election period.

No later than 90 days after the close of the election period, the plan is to complete diversification pursuant to participant elections. The diversification requirement can be satisfied by (1) offering to distribute to the participant an amount equal to the amount for which the participant elected diversification, (2) substituting for the amount of the employer securities for which the participant elected diversification an equivalent amount of other assets, in accordance with the participant's investment direction, or (3) providing the participant the option to transfer (in accordance with applicable qualification rules) the portion of the account balance for which diversification is elected into a qualified plan that provides for employee-directed investment and in which the required diversification options are available. The ESOP, or the transferee plan in the case of a transfer described in (3), is to offer at least 3 investment options (not inconsistent with regulations prescribed by the Secretary).

Explanation of Provision

In order to conform to Congressional intent, the bill clarifies that a qualified participant's qualified election period generally begins with the plan year during which the participant attains age 55 and ends with the fifth succeeding plan year. If, however, the participant has not completed 10 years of plan participation by the end of the plan year in which the participant attains age 55, the qualified election period begins with the plan year in which the participant completes 10 years of plan participation and ends with the fifth succeeding plan year.

For example, in the case of an ESOP using the calendar year as the plan year, a participant who completes 10 years of plan participation before attaining age 55 and who attains age 55 in 1990, becomes a qualified participant in the plan year beginning January 1, 1990. That participant is eligible to direct diversification during the 90-day election period beginning Janaury 1, 1991, and remains eligible to direct diversification during the annual election periods in 1992, 1993, 1994, 1995, and 1996.

Similarly, if the participant completes 10 years of participation in 1990 when the participant is 58, the participant becomes a qualified participant in the plan year beginning January 1, 1990. The participant is eligible to direct diversification during the election periods in 1991, 1992, 1993, 1994, 1995, and 1996.

Under the bill, the qualified election period of any participant does not begin before the first plan year beginning after December 31, 1986. Thus, for example, under the bill, if a participant in a calendar year ESOP attained age 55 and had 10 years of plan participation in 1986, the participant is eligible to make a diversification election during the election periods in 1988, 1989, 1990, 1991, 1992, and 1993.

The bill also clarifies that diversification is to be completed no later than 90 days after the close of the election period, regardless of the method used to implement diversification elections. Thus, diversification is to be completed within the 90-day period regardless of whether diversification is implemented by means of distribution, transfer to another qualified plan which offers the requisite investment options, or reinvestment of employer securities in other assets.

b. Distributions from tax-credit ESOPs

Present Law

An ESOP under which an employer contributes employer securities (or cash with which to acquire employer securities) in order to qualify for a credit against income tax liability is referred to as a tax-credit ESOP. This credit was initially investment-based (and the plans were called TRASOPs due to their origin in the Tax Reduction Act of 1975), but was payroll-based after 1982 (and the plans were called PAYSOPs). The Act repealed the credit with respect to compensation paid or accrued after December 31, 1986.

Tax-credit ESOPs are subject to the requirements generally applicable to qualified plans and ESOPs. In addition, tax-credit ESOPs are subject to special qualification requirements. In general, under present law, employer securities allocated to an employee's account under a tax-credit ESOP may not be distributed before the end of the 84th month after the month in which the securities were allocated. This limitation does not apply to distributions of securities in the case of the employee's separation from service death, or disability, or in the case of certain corporate acquisitions. In addition, under the Act, the 84-month rule does not apply to distributions upon termination of the tax-credit ESOP, effective with respect to plan terminations after December 31, 1984.

Explanation of Provision

The bill clarifies that the exception to the 84-month rule for distributions on termination of a tax-credit ESOP is effective with respect to distributions (rather than plan terminations) occurring after December 31, 1984. This exception is available without regard to whether the employer establishes a successor plan, including an ESOP. The meaning of "termination" for purposes of this rule is to be construed liberally to implement the purposes of the exception, and is not intended to affect the meaning of termination for other purposes.

In order to coordinate the 84-month rule with the new diversification rules, the bill provides that the 84-month rule does not apply to the extent that a distribution is made to satisfy the diversification requirement. This exception to the 84-month rule applies only to the extent that the diversification requirement cannot be satisfied by distributing employer securities that have already met the 84-month rule.

c. Timing of distributions

Present Law

The Act modified the rules relating to the timing and form of required distributions. Under the Act, an ESOP is to permit earlier distributions to employees who separate from service before normal retirement age. Unless an employee otherwise elects in writing, the payment of benefits under an ESOP is to begin no later than 1 year after the close of the plan year (1) in which the participant separates from service by reason of attainment of normal retirement age under the plan, or (2) that is the fifth plan year following the participant's separation from service for any other reason, unless the participant is reemployed by the employer before such year. The Act provided a special rule with respect to the portion of the participant's account (if any) that consists of securities acquired with an exempt loan.

Unless the participant elects otherwise, distribution is to be made in substantially equal payments (not less frequently than annually) over a period not longer than 5 years. Additional time to distribute the account balance is provided if the balance is greater than $500,000. This rule does not preclude more rapid payment.

The rules added by the Act accelerate the otherwise applicable benefit commencement date. Accordingly, if the general rules (secs. 401(a)(9) and 401(a)(14)) require the commencement of distributions at an earlier date, those general rules override the special ESOP rules.

Of course, the special ESOP rules do not permit the employee to elect a form or time of distribution not provided or required to be provided under the plan.

A participant in an ESOP who receives a distribution of employer stock is to be given a put option with respect to distributed employer securities that are not readily tradable. The Act modified the permissible periods over which the employer may pay the option price to the participant and required that where payment is made in installments, the employer is required to provide adequate security with respect to the installment payments. Although the determination of whether securitiy is adequate is generally based on the relevant facts and circumstances, it is not intended that in all cases security is not adequate unless the security involves a lien on the employer's assets higher than all other creditors. Thus, the adequate security requirement may be satisfied by a surety bond or letter of credit.

Explanation of Provision

Under the special distribution rule applicable to ESOPs, the bill provides that, in the case of a separation from service for reasons other than separation on or after normal retirement age, death, or disability, distributions are not required to begin if the participant returns to service with the employer prior to the time distribution is otherwise to begin under the rule.

The special ESOP distribution rules create a conflict with the rules added by the Retirement Equity Act of 1984, which provide that benefits in excess of certain amounts cannot be distributed without the consent of the participant (sec. 411(a)(11)), and that, in certain cases, benefits must be paid in the form of a joint and survivor annuity (secs. 401(a)(11) and 417). The bill provides that the provisions of sections 411(a)(11), 401(a)(11), and 417 are controlling. Thus, for example, distribution to a participant cannot commence under the special ESOP rules unless the applicable consent requirements of sections 411(a)(11), 401(a)(11), and 417 are satisfied.

d. Right to demand employer securities

Present Law

A participant in an ESOP who is entitled to a distribution under the plan has the right to demand that the participant's benefits be distributed in the form of employer securities.

Explanation of Provision

To coordinate with the new diversification rules, the bill provides that a participant does not have the right to demand that benefits be paid in the form of employer securities with respect to the portion of the participant's account that the participant elected to diversify.

e. Voting

Present Law

A defined contribution plan (other than a profit-sharing plan) that is established by an employer whose stock is not publicly traded is required to pass through certain voting rights to plan participants if after acquiring securities of the employer more than 10 percent of the total assets of the plan are securities of the employer (sec. 401(a)(22)). Under the Act, the pass-through voting requirement is eliminated with respect to employer securities issued by an employer whose stock is not publicly traded if a substantial portion of the employer's business consists of publishing a newspaper for general circulation on a regular basis.

In addition, all ESOPs are required to pass through certain voting rights to plan participants. The circumstances under which participants are entitled to exercise voting rights depend on whether the employer has a registration-type class of securities. The Act provides that these voting requirements may be satisfied if the plan permits each participant 1 vote with respect to the issue in question and the plan trustee votes the shares held by the plan in the proportion determined by the votes of participants. This special rule is permissive, that is, an ESOP is not required to provide that participants vote on this basis.

Explanation of Provision

The bill incorporates in the statute the provision in the Statement of Managers that the exception to the voting rules applies to an employer (determined without regard to the controlled group rules) whose business consists of publishing a newspaper for general circulation on a regular basis. Thus, the exception does not apply to members of the controlled group that do not meet this requirement.

The bill replaces the term "not publicly traded" in section 401(a)(22) with the term "not readily tradable on an established market" to conform to the term used in section 409. This change is not intended as a substantive change in the rules of section 401(a)(22).

The bill conforms the 1-vote-per-participant rule to the legislative history by providing that it applies only where the employer does not have a registration-type class of securities.

2. Estate tax deduction for sales to an ESOP (sec. 6671B(g) of the bill, sec. 1172 of the Reform Act, and secs. 409 and 2057 of the Code)

Present Law

In general

The Tax Reform Act of 1986 (sec. 1172 of the Act and sec. 2057 of the Code) adopted a special provision allowing partial relief from estate taxes through an estate tax deduction for sales of employer securities to an employee stock ownership plan (ESOP) or an eligible worker-owned cooperative. This provision was adopted for a temporary period of time to encourage transfers of employer securities to ESOPs. The provision permits a deduction from the gross estate of a decedent equal to 50 percent of the proceeds received from a qualified sale of employer securities. Under the Act, a qualified sale is any sale of employer securities by the executor of an estate to an ESOP or an eligible worker-owned cooperative.

IRS Notice

IRS Notice 87-13 (January 5, 1987) provided that the estate tax deduction for transfers to an ESOP or worker-owned cooperative is not available unless (1) the decedent directly owned the empoloyer securities immediately before death, and (2) after the sale, the employer securities are allocated to plan participants or are held for future allocation in connection with an exempt loan under section 4975 or in connection with a transfer of assets from a defined benefit plan under the rules of section 4980(c)(3). Except in the case of a bona fide business transaction, employer securities are not treated as allocated or held for future allocation to the extent that such securities are allocated or held for future allocation in substitution of other employer securities that had been allocated or held for future allocation.

Reasons for Change

In eacting the estate tax deduction, Congress intended that it would be utilized in a limited number of transactions with a relatively modest revenue loss. As drafted, the estate tax deduction was significantly broader than what was originally contemplated by Congress in enacting the provision. The committee believes it is necessary to conform the statute to the original intent of Congress in order to prevent a significant revenue loss under the Tax Reform Act of 1986.

While Congress intended to encourage transfers of employer securities to ESOPs by providing for partial elimination of estate tax liability, it was not intended that estates be able to eliminate all estate tax liability through use of the deduction or that the securities acquired in a transaction for which the deduction was claimed need not be allocated to plan participants. The provision would not have been adopted in its present form had the full extent of the revenue impact and effect of the provision been recognized.

The committee concludes that it is now necessary to modify the provision to bring the revenue loss in line with the original estimate and Congressional intent. The modifications contained in the bill (which are essentially identical to modifications proposed in S. 591, introduced by Senator Bentsen) are designed to achieve this result while maintaining to the fullest extent possible the incentive to transfer employer securities to ESOPs.

The primiary thrust of the bill is to conform the provisions to the original intent of Congress in enacting the deduction, In this respect, the bill has two elements.

First, the bill makes clear that the positions taken by the Internal Revenue Service in Notice 87-13 with respect to the estate tax deduction are an accurate statement of Congressional intent in enacting the provision. If these clarifications are not made, taxpayers could qualify for the deduction by engaging in essentially sham transactions.

Second, the bill makes additional changes in the deduction which more fully effectuate the intent of Congress to provide limited relief from the estate tax. These changes will give taxpayers and the Internal Revenue Service more administrable guidance as to the requirements that must be satisfied by the decedent and the ESOP and the consequences of failing to satisfy these requirements.

Explanation of Provisions

Confirmation of IRS Notice

The bill confirms the positions taken in IRS Notice 87-13.

Tax-credit ESOPs

The bill clarifies that the estate tax deduction is available in the case of sales of employer securities to tax-credit ESOPs (sec. 409(a)).

Nonpublicly traded stock

The bill limits the deduction to sales of employer securities which are issued by a domestic corporation that has no stock outstanding that is readily tradable on an established securities market.

Estate requirements

Sale by executor.—As enacted, section 2057 would have applied only with respect to sales by the executor of an estate. There are significant issues and potential inconsistencies created by this language. For example, it is common for individuals to structure their estates so that not all the assets are included in the probate estate and subject to the control of the executor. Assets may be in a revocable trust or other similar arrangement which is excluded from the probate estate. In the case of assets held in trust, the statute could be interpreted to preclude the sale of such assets in a transaction qualifying for the estate tax deduction because the executor cannot sell the trust assets.

Congress, is enacting the estate tax deduction, did not intend to draw arbitrary distinctions among the types of assets includible in the gross estate of a decedent depending upon whether the assets are within the control of the executor.

The bill clarifies that the provision applies to sales of employer securities to the extent the securities are includible in the gross estate. Thus, assets held in trust are eligible for the estate tax deduction to the extent the employer securities held by the trust are listed as securities on the estate tax return. On the other hand, if a decendent owned a partnership interest, the value of the partnership interest is reported on the estate tax return and not the value of the underlying assets of the partnership. Consequently, under the provision, if the assets of a partnership consisted of employer securities, such securities may not be sold in a transaction qualifying for the estate tax deduction.

Limitation on deduction.—In order to ensure that the provision results in only a partial elimination of estate tax liability, the bill limits the amount of the deduction allowable under section 2057 to 50 percent of the taxable estate (determined without regard to sec. 2057). Also, the amount of estate taxes imposed by section 2001 (determined without regard to any credits allowable against the tax) may not be reduced by more than $750,000 by reason of the deduction.

Holding period requirement.—In order to prevent transfers is contemplation of death, the bill imposes a holding period requirement for the decedent with respect to the employer securities to be sold to an ESOP. Thus, in order for the estate tax deduction to be available, the securities are required to be assets that would be includible in the gross estate of the decedent if the decendent died at any time during the shorter of (1) the 5-year period ending on the date of death, or (2) the period beginning on October 22, 1986, and ending on the date of death. For purposes of determining whether the holding period requirement has been satisfied, securities which would be includible in the gross estate of the spouse of the decedent if the spouse died during the holding period are to be treated as securities includible in the gross estate of the decedent during such period. In the case of the estate of a decedent who died before October 22, 1986, the holding period requirement is satisfied if the decedent held the employer securities on the date of death.

The period for which the decedent is considered to have held the stock is reduced for any period for which the holding period is reduced under section 246(c)(4) (relating to periods in which the risk of loss is diminished).

Assets transferred from other plans.—The bill provides that the estate tax deduction does not apply to the extent that the employer securities are acquired with transferred assets. Transferred assets are assets of an ESOP which are attributable to assets held by another qualified plan maintained by the employer (other than another ESOP) or assets attributable to a period of time when a plan was not an ESOP. Assets held by the ESOP on February 26, 1987, are not transferred assets, regardless of their source. The denial of the deduction extends to assets that are transferred directly from one plan to another (for example, pursuant to section 4980(c)(3)), assets which are rolled over from another plan, assets which result from a conversion of another plan into an ESOP, and assets which are merged into an ESOP from another plan (other than an ESOP). The Secretary has the authority to except assets from this provision under appropriate circumstances.

In order to prevent the employer from acquiring securities in a section 2057 transaction with the proceeds of a loan and then using transferred assets to make payments on the loan, the bill imposes an excise tax if a loan payment is made with transferred assets. The tax is imposed on the employer maintaining the ESOP and is equal to 30 percent of the amount paid on the loan (including both principal and interest payments). This provision is not intended to expand the permissible sources from which exempt loans can be repaid pursuant to section 4975.

ESOP allocation requirements and substitution prohibition

In general.—The bill modifies the allocation requirement and nonsubstitution requirement in present law (as reflected in the IRS Notice) in several respects. The modifications provide objective rules for determining when a prohibited substitution of employer securities occurs and also change the sanctions for failing to allocate the securities acquired in the section 2057 transaction or acquiring securities in substitution for other employer securities. The new provisions are intended to ensure that plan participants receive the employer securities acquired in a section 2057 transaction (or the proceeds of a disposition thereof) and that the transaction results in an increase in employer securities in the plan.

Dispositions within 1 year preceding sale.—The bill prohibits an ESOP from selling employer securities and using the proceeds to acquire substitute employer securities in a section 2057 transaction. Further, the bill modifies this nonsubstitution rule contained in present law (as reflected in the IRS Notice) to provide that the deduction is available with respect to proceeds from a sale to an ESOP only to the extent the proceeds are greater than the excess (if any) of (1) the proceeds from the disposition of employer securities during the 1-year period preceding the sale, over (2) the cost of employer securities purchased by the plan during such 1-year period. In addition, for purposes of the rule, all ESOPs of the employer are treated as a single plan.

In determining the proceeds of the plan from dispositions of employer securities, the following dispositions are not taken into account: (1) distributions made on account of the death or disability of the employee, the retirement of the employee after the attainment of age 59½, or a separation from service of the employee which results in a 1-year break in service; (2) certain exchanges of qualified employer securities for other employer securities in a corporate reorganization; and (3) dispositions required to meet diversification requirements (section 401(a)(28)).

This provision can be illustrated by the following example: On July 1, 1988, executor E sells employer securities to an ESOP. The proceeds of the sale are $150,000. During the 1-year period from July 2, 1987, through July 1, 1988, the cost of employer securities acquired by the plan and all other ESOPs maintained by the employer (excluding the purchase from executor E) is $350,000. The proceeds of the ESOP (and all other ESOPs maintained by the employer) from the disposition of employer securities during the same period (excluding any dispositions excepted from the provision) is $400,000. The estate tax deduction is not available with respect to $50,000 of the proceeds received by executor E and is available with respect to $100,000.

Dispositions within 3 years following sale.—To preclude an ESOP from disposing of qualified securities within 3 years of the date of a sale qualifying for the estate tax deduction, an excise tax is imposed on the employer maintaining the ESOP. The tax is equal to 30 percent of the amount realized on the disposition. No penalty tax is imposed on dispositions which are excepted from the provision prohibiting dispositions within the one-year period preceding the sale. The bill contains ordering rules for determining which securities are considered disposed of in any disposition.

The 30-percent excise tax does not apply to dispositions of securities with respect to which the estate tax deduction is denied due to a failure to meet the nonsubstitution requirement.

Failure to allocate.—The bill imposes an excise tax on the employer maintaining the ESOP in the event of a failure to allocate securities acquired in a section 2057 transaction. The tax is equal to 30 percent of the amount realized on the disposition of qualified employer securities before the securities are allocated to the accounts of plan participants if the proceeds from such disposition are not so allocated. This excise tax is coordinated with the tax on distributions within 3 years following the sale, so that this tax does not apply to dispositions to which the premature disposition tax applies.

The tax applies in a number of situations to which the tax on premature dispositions does not apply. For example, the tax applies if the shares were disposed of after expiration of the 3-year period in order to repay an exempt loan.

Taken together with the 3-year rule, this provision requires that, within the 3-year holding period, employer securities are to be allocated to plan participants or held for allocation. After expiration of the 3-year holding period, the securities may be sold, but the entire proceeds of the sale (including any amounts owing on an exempt loan) are to be allocated to plan participants.

The 30-percent excise tax does not apply to dispositions of securities with respect to which the estate tax deduction is denied due to a failure to meet the nonsubstitution requirement.

Effective Dates

Confirmation of IRS Notice

Because this provision of the bill accurately reflects Congressional intent in enacting the estate tax deduction, it is effective as if included in the Tax Reform Act of 1986.

Tax-credit ESOPs

This provision is effective as if included in the Tax Reform Act of 1986.

Nonpubliciy traded stock

This provision is effective with respect to sales after February 27, 1987.

Estate requirements

Sale by executor.—This provision is effective as if included in the Tax Reform Act of 1986.

Limitation on deduction.—This provision is effective with respect to sales of employer securities to an ESOP after February 27, 1987. Sales on or before February 27, 1987, are not subject to the limitations in the provision, but are taken into account in determining whether the limitations are met with respect to post-effective date sales.

Holding period requirement.—This requirement is effective with respect to sales to an ESOP after February 27, 1987.

Assets tranferred from other plans.—This provision is effective with respect to sales to an ESOP after February 27, 1987, and, in the case of transfers used to make payments on a loan, transfers used after February 27, 1987.

ESOP allocation requirements and substitution prohibition

Dispositions within 1 year preceding sale.—This provision is effective with respect to sales to an ESOP after February 27, 1987.

Dispositions within 3 years following sale.—This provision is effective with respect to dispositions by the ESOP after February 27, 1987. The 30-percent excise tax does not apply to dispositions of securities with respect to which the estate tax deduction is denied due to a failure to meet the nonsubstitution requirement.

Failure to allocate.—This provision is effective with respect to failures to allocate employer securities occurring after February 27, 1987.

3. Partial exclusion of interest earned on ESOP loans (sec. 6671B(h) of the bill, sec. 1173 of the Reform Act, and sec. 133 of the Code)

Present Law

In general

Under present law, a bank, an insurance company, regulated investment company, or a corporation activity engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan. A "securities acquisition loan" is generally defined as a loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities (within the meaning of section 409(1)) for the ESOP. There has been some uncertainty as to the availability of the partial interest exclusion with respect to refinancings of the various types of securities acquisition loans.

Back-to-back loans

The Act clarified the definition of a securities acquisition loan in the case of a loan to a corporation with a corresponding loan to an ESOP that is exempt under section 4975 (a back-to-back loan). The Act provides that a loan to a sponsoring corporation will qualify as a securities acquisition loan if the terms of such loan are substantially similar to the terms of the corresponding exempt loan from the corporation to the ESOP. In addition, the Act provides that, if the terms of the 2 loans are not substantially similar, the loan to the sponsoring corporation will still qualify as a securities acquisition loan if (1) the corresponding loan to the ESOP provides for more rapid payment of principal or interest than the loan to the sponsoring corporation; (2) the allocations of stock within the ESOP attributable to the difference in payment schedules do not result in discrimination in favor of highly compensated employees; and (3) the total commitment period of the loan to the sponsoring corporation is not more than 7 years.

The 7-year limitation applies to the total commitment period. Thus, provided the final maturity of the credit arrangement is not greater than 7 years, the funds may be provided by 1 or more lenders in a series of shorter maturity loans, each of which (other than the first) is used to repay the preceding loan.

The 7-year limitation on the term of the loan does not apply to loans directly from a commercial lender to an ESOP or to back-to-back loans if the terms of the loans are substantially similar. For example, assume a bank makes a loan to employer X within a term of 10 years and employer X in turn makes a loan to its ESOP. If the terms of the 2 loans are substantially similar, then the partial interest exclusion is available for the entire 10-year commitment period of the loan. Similarly, the partial interest exclusion applies for the entire commitment period of the loan if the loan is made directly from the bank to the ESOP.

Immediate allocation loans

The Act extended the definition of "securities acquisition loan" to include certain loans to a corporation that are used by the corporation to purchase employer securities that are immediately allocated to employees' accounts. Thus, the partial exclusion is available with respect to interest paid on a loan to a corporation to the extent that (1) within 30 days of the date of the loan, employer securities are transferred to the ESOP in an amount equal to the proceeds of the loan, (2) such contributions are allocable to accounts of plan participants within 1 year of the date of the loan, and (3) the total commitment period of the loan does not exceed 7 years.

As in the case of other loans to which the 7-year limitation applies, the limitation applies to the total commitment period. Thus, provided the final maturity of the credit arrangement is not greater than 7 years, the funds may be provided by 1 or more leaders in a series of shorter maturity loans, each of which (other than the first) is used to repay the preceding loan.

Refinancings

The Act provided that, in certain cases, the refinancing of a securities acquisition loan (other than an immediate allocation loan or a back-to-back loan that has terms that are not substantially similar, which are discussed above) may also qualify as a securities acquisition loan.

All refinancings, including refinancings of back-to-back loans that are not substantially similar, are required to comply with section 4975.

Explanation of Provision

In general

The bill clarifies the availability of the partial interest exclusion in the case of refinancings of the various types of securities acquisition loans.

Back-to-back loans

The bill provides that, with respect to back-to-back loans the terms of which are not substantially similar, if the total commitment period of the loan is extended beyond 7 years, the partial exclusion will be available, but for the first 7 years of the loan only. This 7-year period begins as of the date of the original loan. The provision is effective with respect to a loan used to acquire employer securities after July 18, 1984, and a loan made after July 18, 1984, that is used (or is part of a series of loans used) to refinance a loan that (1) was used to acquire employer securities after July 18, 1984, and (2) met the requirements of section 133 (other than subsection (b)(2) thereof) as in effect at the time the loan was made.

Immediate allocation loans

The bill provides that, with respect to immediate allocation loans, if the total commitment period is extended beyond 7 years, the partial interest exclusion will be available, but for the first 7 years of the loan only. This 7-year period begins as of the date of the original loan. This provision is effective as if included in the Act.

Refinancings

The bill provides that a loan to an ESOP (other than an immediate allocation loan of a back-to-back loan that has terms that are not substantially similar) after July 18, 1984, that is used (or is part of a series of loans used) to refinance a loan will qualify as a securities acquisition loan provided that (1) the original loan met the requirements of section 133 (other than subsection (b)(2) thereof) as in effect on the date of the loan, or, if later, July 19, 1984; and (2) the original loan was used to acquire employer securities after May 23, 1984. Immediate allocation loans and back-to-back loans that have terms that are not substantially similar are described above.

Under the bill, if a securities acquisition loan (other than an immediate allocation loan or a back-to-back loan that has terms that are not substantially similar) is refinanced and as a result the total commitment period exceeds the greater of the original commitment period or 7 years, then the partial exclusion would continue to apply, but only during the first 7 years of the commitment period (measured from the date of the original loan) or the original commitment period, whichever is greater. For example, if an otherwise qualified securities acquisition loan to an ESOP with an original commitment period of 5 years is refinanced and the commitment period is extended for 2 years (for a total commitment period of 7 years), the partial exclusion would apply during the entire 7 years of the loan.

Under the bill, as under the Act, if the terms of the back-to-back loans are no longer substantially similar as a result of the refinancing, the partial exclusion would be available only during the first 7 years of the loan.

4. Sales of stock to an ESOP (sec. 6680(q) of the bill, sec. 1854 of the Reform Act, and secs. 404, 409, and 1042 of the Code)

Present Law

A taxpayer may elect to defer recognition of gain on the sale of certain qualified securities to an ESOP or to an eligible worker-owned cooperative to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period (sec. 1042).

Prior to the Act, nonrecognition treatment was not available if any portion of the assets attributable to employer securities acquired in a qualified sale (or assets in lieu thereof) accrued or were allocated during the nonallocation period for the benefit of (1) the taxpayer involved in the nonrecognition transaction, (2) any member of the taxpayer's family (within the meaning of sec. 267(b)), or (3) any other person who owned (after application of the sec. 318 attribution rules) more than 25 percent in value of any class of outstanding securities. Temporary Treasury regulations provided that, for purposes of determining whether an individual is a 25-percent shareholder, stock that is owned directly or indirectly by or for a qualified plan is not treated as outstanding (Temp. Treas. reg. sec. 1042-1T Q&A 2(a)(3)).

The Act made several changes with respect to the nonallocation requirement. In particular, for purposes of determining whether an individual is a 25-percent shareholder, the Act provides that the allocation rules of section 318(a) are applied, without regard to the employee trust exception in paragraph (2)(B)(i). Thus, all allocated securities held by an ESOP are treated as securities owned by the ESOP participant and are also treated as outstanding securities. This provision is effective with respect to sales of securities after October 22, 1986.

An excise tax is imposed with respect to certain dispositions of employer securities within 3 years of the date of a sale to which section 1042 applies (sec. 4978).

Explanation of Provision

In order to conform the statute to Congressional intent, the bill clarifies that the nonallocation period is the period beginning on the date of the sale and ending on the later of (1) the date that is 10 years after the date of sale or (2) the date of the plan allocation attributable to the final payment of acquisition indebtedness incurred in connection with such sale.

In some situations, the rules for determining whether an individual is a 25-percent shareholder may be more favorable under the Act than under prior law. The provision of the Act, however, is effective prospectively only. The bill provides that, for purposes of determining whether an individual is a 25-percent shareholder with respect to sales occurring before October 22, 1986, in taxable years beginning after July 18, 1984, all allocated securities held by qualified plans may be treated as outstanding with respect to the individual if securities allocated to the individual under the qualified plans are treated as securities owned by the individual. This rule applies consistently to all individuals with respect to any sales to which section 1042 applies.

The bill provides that the excise tax on certain distributions (sec. 4978) does not apply to employer securities which are required to be disposed of pursuant to the new diversification rules.

5. Dividends paid deduction (sec. 6671B(h) of the bill, sec. 1173 of the Reforn Act, and sec. 404(k) of the Code)

Present Law

Subject to certain requirements, an employer may deduct dividends paid in cash on employer stock held by an ESOP if, in accordance with the plan provisions, (1) the dividend is paid in cash to the plan participants or their beneficiaries, (2) the dividend is paid to the plan and distributed to participants or beneficiaries not later than 90 days after the close of the plan year in which paid, or (3) the dividend with respect to employer securities is used to make payments on a loan described in section 404(a)(9) (sec. 404(k)).

Explanation of Provision

The bill provides that, with respect to dividends used to make payments on a loan described in section 404(a)(9), the dividend deduction is available with respect to dividends on both unallocated and allocated ESOP securities. However, dividends on allocated ESOP securities may be used to make payments on such a loan only if the account to which the dividend would have been allocated is allocated employer securities with a fair market value not less than the amount of the dividend that would have been allocated. In addition, such allocation is required to be made in the year the dividend would otherwise have been allocated.

The bill also provides that use of dividends to repay an acquisition loan in accordance with section 404(k) does not violate the prohibited transaction rules of section 4975(d)(3) or the corresponding section of ERISA.

Securities released from an acquisition loan expense account by use of dividends on allocated shares may be used to satisfy the minmum allocation requirement. Of course, such allocations must otherwise satisfy section 4975 and applicable qualification rules.

H. Technical Corrections to the Retirement Equity Act of 1984 (Sec. 6680q) of the Bill, Sec. 1898 of the Reform Act, Secs. 414(p), 417, 2039 and 2517 of the Code, and Sec. 205 of ERISA)

Present Law

Under present law, a plan is required to notify participants of their rights to decline a qualified preretirement survivor annuity before the applicable election period. Under the Act, the period during which notice is required to be provided to an individual is the latest of the following periods: (1) the period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year in which a participant attains age 35; (2) a reasonable period of time after the individual becomes a plan participant; (3) a reasonable period of time after the survivor benefit applicable to a participant is no longer subsidized (as defined in sec. 417(a)(4); (4) a reasonable period of time after the survivor benefit provisions (sec. 401(a)(11)) become applicable with respect to a participant; or (5) a reasonable period after separation from service in the case of a participant who separates from service before attaining age 35.

Under the Act, the waiver of a survivor annuity under section 401(a)(11) or section 417 is not treated as a transfer of property by gift (sec. 2503(f)).

The Code provides rules with respect to procedures applicable to and taxation of benefits under qualified domestic relations orders (QDROs). The QDRO rules do not apply to plans that are not subject to the assignment or alienation restrictions of the Code and, therefore, do not apply to governmental plans or to tax-sheltered annuities (sec. 403(b)).

Explanation of Provision

The bill clarifies that the notice period in the case of a participant who separates from service before age 35 overrides any other period during which notice might be required. In such a case, the bill provides that the notification period is a reasonable period after separation from service and such notice period is not included in the list of notice periods the last of which applies.

This provision is effective for distributions after the date of enactment of the bill.

The bill addresses certain estate and gift tax issues which arise as a result of the survivor benefit rights created by the Retirement Equity Act. Under the bill, the value of an annuity or other payment receivable by the spouse of a decedent under a qualified pension arrangement is excluded from the gross estate. The exclusion does not apply to the portion of the annuity or other payment which bears the same ratio to such amount as the payments or contributions made by the decedent bears to the total payments or contributions made. The bill also provides that, if a qualified pension arrangement provides an employee with an option or election under which an annuity or other payment will become payable to the spouse of the employee at or after the employee's death, the exercise or nonexercise of such option or election is not considered a transfer for gift tax purposes.

The bill provides that the QDRO rules, including the rules relating to taxation of distributions pursuant to a QDRO, apply to tax-sheltered annuitites except as provided in regulations. This extension of application of the QDRO rules will provide more certainty with respect to treatment of domestic relations orders and will provide for uniform tax treatment of such orders with respect to qualified plans and tax-sheltered annuities. The committee believes that, because the nonalienation provision of the Code do not apply to tax-sheltered annuities, it may be appropriate for the Secretary to exempt such annuities from some of the procedural requirements applicable to QDRO's.

I. Miscellaneous Benefit and Pension Technicals

1. Health care continuation (sec. 6680(q) of the bill, sec. 1895 of the Reform Act, sec. 162(k) of the Code, sec. 602 of ERISA, and sec. 2202 of the Public Health Service Act)

Present Law

Under the health care continuation rules, continuation coverage provided may be terminated upon the occurrence of certain events. One such event is the coverage of the qualified beneficiary under the group health plan of an employer other than the employer providing the continuation coverage.

Explanation of Provision

Under the bill, if a qualified beneficiary becomes covered under a group health plan of an employer other than the employer providing the continuation coverage, but such group health plan does not cover a preexisting condition that was covered by the continuation coverage, the qualified beneficiary's continuation coverage may not be terminated due to the coverage under the other employer's plan.

This provision is intended to carry out the purpose of the health care continuation rules, which was to reduce the extent to which certain events, such as the loss of one's job, could create a significant gap in health coverage. If another employer's plan that excludes preexisting conditions could terminate the right to continuation coverage, then continuation coverage would be terminated by an event that may do very little to address the particular health care needs of the qualified beneficiary, thus leaving a significant gap in health coverage during what would otherwise be the period of continuation coverage.

This provision applies to plan years beginning after December 31, 1987. Of course, this provision does not apply to a plan prior to the date that the health care continuation rules generally apply to the plan.

2. Miscellaneous pension technical correction (sec. 6687(e) of the bill, sec. 9202 of the Omnibus Budget Reconciliation Act of 1986, and sec. 411(a)(8) of the Code)

Present Law

Under present law, for purposes of the qualified plan rules, the term "normal retirement age" means the earlier of (1) normal retirement age under the plan, or (2) the latest of (a) age 65, (b) in the case of a participant who commences participation in the plan within 5 years before attaining normal retirement age under the plan, the 5th anniversary of the commencement of participation, or (c) in the case of a participant not described in (b), the 10th anniversary of the commencement of participation.

Explanation of Provision

Under the bill, normal retirement age is defined to mean the later of (1) age 65, or (2) the 5th anniversary of the time a plan participant commenced participation in the plan.

XII. Foreign Tax Provisions (Sec. 6674 of the Bill)

A. Foreign Tax Credit (Sec. 6674(a)-(c) of the Bill, secs. 1201, 1202, and 1203 of the Reform Act, and Secs. 864, 902, and 904 of the Code)

Under the foreign tax credit system, the United States reserves the right to collect full U.S. income tax on U.S. persons' foreign income, less a limited amount of foreign income tax imposed on that income. The mechanics of the foreign tax credit are such that the United States may collect little or no residual U.S. tax—after aggregate foreign taxes are credited—on income that is taxed abroad at below the U.S. rate. This results where the law permits a cross-crediting of taxes, sometimes referred to as "averaging": that is, where taxpayers are permitted to credit high foreign taxes paid on one stream of income against the residual U.S. tax otherwise due on other, lightly taxed foreign income.

While the Code does not eliminate all cross-crediting among types of differently taxed income, it has in the past separated types of income for credit purposes, most recently based on the character, rather than the country of origin, of income. The Act further separated certain income into the following newly defined "baskets": passive income, high withholding tax interest, financial services income, shipping income, and dividends from each noncontrolled section 902 corporation.

1. Separate application of foreign tax credit provisions to financial services income

Present Law

The "predominatly engaged" test and the priority of the financial services income basket

The financial services income basket applies not only to income earned by an entity *predominantly engaged* in the active conduct of a banking, insurance, financing, or similar business, but also to income earned by a person in the active conduct of a banking, financing, or similar business, or earned in connection with certain insurance activities, even if that person is not predominantly so engaged. The types of income that the Act places in the financial services income basket of a "predominantly engaged" entity are not limited to the types of income included in the financial services basket of a person not predominatly engaged. For example, income that would otherwise be passive is treated as financial services income in the hands of a predominantly engaged entity, but remains passive in the hands of an entity that is not predominantly engaged.

On the other hand, Congress intended that dividends from each noncontrolled section 902 corporation would be subject to their own separate limitation regardless of whether those dividends also met the definition of financial services income (or of passive income or shipping income or of any other separate limitation type of income).

Generally, the Act places certain export financing interest in the overall limitation basket, that is, outside the separately defined limitation baskets, regardless of whether the entity deriving the interest is engaged in financial services. In addition, the financial services income basket excluded high withholding tax interest. Where a predominantly engaged entity earns interest qualifying as export financing interest that is subject to a 5-percent or greater gross basis tax, however, Congress intended that such interest be treated as financial services income.

Modification of the look-through rule to prevent avoidance of the purpose of the separate limitations

Under the Act's look-through provisions for characterizing certain types of income that a U.S. shareholder derives from a controlled foreign corporation, interest income of the shareholder is generally to be treated as financial services income (without regard to high withholding taxes or other circumstances that would ordinarily shift such interest out of the shareholder's financial services income basket) to the extent that the interest payment is properly allocable to financial services income of the controlled foreign corporation. At the same time, the Act requires the IRS to prescribe such regulations as may be necessary or appropriate to prevent manipulation of the character of income the effect of which is to avoid the purposes of the separate limitations. In granting this regulatory authority Congress intended that athe IRS invoke it to modify, in some cases, the application of the look-through rule.

For example, if a U.S. person lends funds directly to an unrelated foreign person whose country of residence imposes a withholding tax of at least 5 percent on the interest paid on the loan, then the interest is high withholding tax interest subject to the separate limitation for such interest. United States banks might take the position, however, relying upon the look-through rule for interest, that they can avoid the separate limitation for high withholding tax interest by lending funds to such a borrower through a subsidiary that is a controlled foreign corporation incorporated in the borrower's country, rather than lending those funds directly. Taxpayers might argue that, under the look-through rule for interest, interest received in turn by the U.S. bank from the foreign subsidiary will not be high withholding tax interest, even though it attracts the foreign country's high withholding tax.

Because such a result would undermine the separate limitation for high withholding interest, Congress intended that it be precluded under the anti-avoidance regulations. It was expected that such regulations might treat the interest received by the U.S. bank from the foreign subsidiary in this example as high withholding tax interest.

Overall basket treatment of highly taxed financial services income of a controlled foreign corporation

Where the taxpayer establishes to the satisfaction of the Secretary, pursuant to Code section 954(b)(4), that income of a controlled foreign corporation was taxed at over 90 percent of the maximum federal rate, the Act provides that dividends paid by the controlled foreign corporation out of its financial services income (as well as dividends paid out of the controlled foreign corporation's passive income and shipping income) are to be treated as overall basket income to the taxpayer.

Explanation of Provision

The predominantly engaged test and the priority of the financial services income basket

Under the bill only income of persons predominantly engaged in the active conduct of a banking, insurance, financing, or similar business is treated as financial services income. The bill therefore simplifies the foreign tax credit somewhat, relieving taxpayers from the necessity of computing a separate limitation with respect to a very limited type of income (i.e., non-passive, financial services income of an entity not predominantly engaged in providing such services).

The bill clarifies that dividends from a noncontrolled section 902 corporation which would otherwise meet the definition of financial services income are placed in the separate basket for that corporation's dividends. Thus the bill prevents banks and other financial businesses from receiving unintended relief from the 902 basket provisions not available to non-financial businesses.

Where a predominantly engaged U.S. person earns export financing interest (as defined by the Act) that is subject to a 5-percent or greater gross basis tax, the bill clarifies that this interest is financial services income, rather than overall limitation income. In general, this treatment makes it clear that the Code allows cross-crediting of high taxes on such income against U.S. tax on lower-taxed financial services income, supplementing the favored treatment provided in the Act that allows cross-crediting of high taxes on overall basket income against U.S. tax on lower-taxed export financing interest.

Modification of the look-through rule to prevent avoidance of the purpose of the separate limitations

The bill partially eliminates the look-through treatment of interest subject to 5-percent or greater gross basis tax that is paid to a U.S. shareholder by a controlled foreign corporation out of income that would otherwise be treated under the look-through rules as financial services income. In these circumstances look-through treatment would apply only to that portion of the interest payments that exceed the payor's interest income (or its equivalent) that would be treated as financial services income under the look-through rule. This provision makes it clear that lenders are prevented from shifting high withholding tax interest into the financial services basket by the mere interposition of a controlled local entity between themselves and foreign borrowers. At the same time, however, if a controlled foreign corporation's interest payments to its U.S. shareholder are subject to a 5-percent or more gross-basis tax, and they exceed by $100 the foreign corporation's interest income (or its equivalent) that would, under a look-through approach, be treated at the U.S. shareholder level as financial services income, then the U.S. shareholder would be afforded look-through treatment on that $100 of interest received from the subsidiary.

Overall basket treatment of highly taxed financial services income of a controlled foreign corporation

The bill provides for separate basket treatment of dividends paid by controlled foreign corporations where paid out of latter's financial services income (or shipping income), even where it has been established pursuant to section 954(b)(4) that the controlled foreign corporation's income was taxed by a foreign government at more than 90 percent of the maximum U.S. rate. Thus, for example, a dividend from a highly taxed banking subsidiary will be available for cross-crediting against U.S. tax on other lower-taxed financial services income of the parent.

2. Shipping income

Present Law

The Act establishes a separate foreign tax credit limitation for shipping income. This limitation applies to income received or accrued by any person which is of a kind that would be foreign base company shipping income under Code sec. 954(f). The Act did not provide express ordering rules to determine the correct basket for income that could be placed in the shipping basket or a basket for dividends from a noncontrolled section 902 corporation. However, as indicated above, Congress intended the baskets for section 902 corporations to take priority over the shipping basket.

As in the case of financial services income described above, where the taxpayer establishes to the satisfaction of the Secretary that income of a controlled foreign corporation was taxed at over 90 percent of the maximum federal rate, the Act provides that dividends paid by the controlled foreign corporation out of its shipping income are to be treated as overall basket income to the taxpayer.

Explanation of Provision

The bill provides that dividends from a noncontrolled section 902 corporation that might otherwise constitute shipping income are to be placed in that corporation's dividend basket rather than the shipping basket, consistent with Congress' intent generally to give first priority to the section 902 dividend baskets.

As in the case of financial services income, the bill provides for separate basket treatment of dividends paid by a controlled foreign corporation out of its shipping income when the taxpayer establishes to the satisfaction of the Secretary that the income was taxed by a foreign government at more than 90 percent of the maximum U.S. rate. Thus, taxpayers may cross-credit taxes on a highly taxed shipping income against the U.S. tax on other shipping income they may earn.

3. High withholding tax interest

Present Law

Definition of high withholding tax interest

The Act defines high withholding tax interest generally as any interest (other than export financing interest) subject to a foreign withholding tax (or other tax determined on a gross basis) of 5 percent or more. The Act further states that the Secretary may by regulations provide that amounts (not otherwise high withholding tax interest) will be treated as high withholding tax interest where necessary to prevent avoidance of the purpose of the separate limitations. Congress intended these rules to encompass foreign gross-basis taxes and other taxes that are substantially similar in the sense that their imposition results in heavier taxation by the levying country of foreign lenders than of residents.

Transition rule for high withholding tax interest on qualified loans

Generally for taxable years beginning after December 31, 1986, interest income subject to a foreign withholding tax or other gross basis tax of 5 percent or more (other than export financing interest) is "high withholding tax interest" subject to its own separate foreign tax credit treatment. A special transition rule applies, however, to certain interest on certain loans to any of 33 foreign countries or to any resident of one of those countries for use in that country. The applicability of the transition rule turns on the amount of loans held by the taxpayer on November 16, 1985 and during subsequent taxable years.

Explanation of Provision

Definition of high withholding tax interest

The bill gives the secretary authority to exclude from the definition of withholding taxes, for these purposes, those taxes that are in the nature of a prepayment of a tax imposed on a net basis, where the tax in question is otherwise free of those characteristics of a gross-basis tax that would warrant treatment as high withholding taxes. Thus, the bill makes clear that where a foreign taxing authority uses withholding simply as a collection mechanism (as does the United States in the cases of ordinary wage withholding and backup withholding on certain interest, dividend, and other reportable payments under Code section 3406), it will not necessarily follow that the mechanism results in interest being treated as high withholding tax interest.

Transition rule for high withholding tax interest on qualified loans

The bill provides that for purposes of this transition rule, all members of an affiliated group of corporations filing a consolidated return shall be treated as one corporation. (Under this rule, intercompany loans are eliminated.) Thus, for members of a consolidated group, the transition relief will be available regardless of, and will be limited without regard to, the particular group member holding qualified loans on November 16, 1985, or during the relevant subsequent taxable year.

4. Passive income

Present Law

Related party factoring income

Under the related party factoring rules of the Tax Reform Act of 1984, any income of a controlled foreign corporation from a loan to a person for the purpose of financing the purchase of inventory property of a related person was interest for separate foreign tax credit limitation purpose without regard to the exceptions to prior law's separate limitation for interest. Under the 1986 Act, such income of a controlled foreign corporation is also ineligible for the export financing exception to the new separate limitations (sec. 864(d)(5)(A)(i)). In the case of passive income, this result follows because the Act defines passive income generally as income "of a kind which would be foreign personal holding company income" (Code sec. 904(d)(2)(A)(i)); if export financing interest fits that description, the related party factoring rules make unavailable the export financing exception from passive basket treatment which would otherwise be available.

Congress did not intend that the availability of the export financing exception for interest received directly by *U.S. persons* (rather than by controlled foreign corporations) be restricted by the 1984 factoring rule governing loans made to finance inventory property purchases, or by the analogous 1986 rule. However, the phrase "of a kind which would be foreign personal holding company income" arguably leads to an inference that interest income earned directly by U.S. persons (i.e., interest that would be foreign personal holding company income if the recipient was a controlled foreign corporation) is ineligible for overall basket treatment under the export financing exceptions.

Income inclusions under sections 551 and 1293

Foreign personal holding company inclusions (under Code sec. 551) and passive foreign investment company inclusions (under new Code sec. 1292) are passive income. In the case of a passive foreign investment company inclusion, Congress intended that the high-tax kick-out shift the inclusion to the overall limitation basket, however, if the creditable foreign tax with respect to the inclusion exceeds the U.S. tax on the inclusion.

Explanation of Provision

Related party factoring income

The bill clarifies that in determining whether income is "of a kind which would be foreign personal holding company income" the related person factoring rules applicable to controlled foreign corporations shall apply only in the case of an actual controlled foreign corporation. Thus, income earned directly by a U.S. person may be eligible for the applicable export financing exceptions.

Income inclusions under sections 551 and 1293

The bill clarifies that income inclusions under section 1293 are subject to recharacterization (e.g., by virtue of the high-tax kick-out), as are other kinds of income generally categorized as passive.

5. Dividends from noncontrolled section 902 corporations

Present Law

The Act defines "dividends from each noncontrolled section 902 corporation" and subjects them to separate foreign tax credit limitations. Congress intended that these separate limitations would govern only those taxpayers that might, by virtue of the dividends, be entitled to deemed paid foreign tax credits. Generally under present and prior law, only a corporate taxpayer whose stock holdings in the dividend payor meet a 10 percent threshold can be entitled to a deemed paid credit on the dividend.

Dividends from a controlled foreign corporation are not subject to the separate limitation when the former come from income the corporation earned *as* a controlled foreign corporation. Generally, Congress intended the look-through rules for distributions by controlled foreign corporations to apply to those dividends.

Explanation of Provisions

The bill clarifies that any taxpayer that is not a corporation, and thus is not eligible to receive deemed paid credits on dividends from a foreign corporation, is not subject to the separate limitations for dividends from noncontrolled section 902 corporations.

The bill also provides that dividends from controlled foreign corporation, out of earnings for periods during which the dividend recipient was not a U.S. shareholder with respect to the corporation, will be treated as dividends from a noncontrolled section 902 corporation. Thus, the bill implements the Act's policy of preventing cross-crediting of taxes between income earned by a taxpayer and income derived by an entity within which the taxpayer does not hold a majority interest, either alone or in combination with other U.S. shareholders. For example, a U.S. person that becomes a U.S. shareholder of a controlled foreign corporation cannot use the look-through rule to cross-credit foreign taxes paid (or deemed paid) by the corporation prior to the taxpayer's stock ownership against U.S. tax on the taxpayer's other income. Nor can the taxpayer cross-credit foreign withholding taxes paid on dividends out of earnings from the pre-ownership period against U.S. taxes on income other than dividends from that corporation. By the same token, the taxpayer cannot credit its other foreign taxes against U.S. tax on those dividends.

6. Separate application of foreign tax credit limitation to income of controlled foreign corporations under the look-through rules in general

Present Law

Payments by controlled foreign corporations to U.S. shareholders

A payment of interest, rent, or a royalty is ordinarily characterized as separate or overall limitation income under the general rules defining the new separate limitation categories (sec. 904(d)(2)). Under the look-through rules of new Code section 904(d)(3), however, any interest, rent, or royalty which is received or accured from a controlled foreign corporation by a U.S. shareholder will be treated as separate category income to the extent it is properly allocable to separate category income of the controlled foreign corporation.

Without a mechanism to determine which set of rules takes precedence, the application of the look-through rules, on the one hand, and the general definitions of 904(d)(2), on the other, could produce conflicting results. For example, interest paid to a U.S. shareholder by a controlled foreign corporation earning only overall limitation income may be subject to a high withholding tax. Also, interest may be paid by a controlled foreign corporation to its U.S. shareholder to finance sales by the U.S. shareholder. On the one hand, this interest may qualifiy as export finance interest; on the other hand, the interest may be properly allocable to the controlled foreign corporation's income unrelated to export financing.

Congress intended that the question whether interest received from a controlled foreign corporation by a U.S. shareholder of the corporation is overall limitation income or a separate limitations type of income generally depends upon the look-through rules, not upon whether the payment was made to finance an export or upon whether the payment bore a high withholding tax. In the case of high withholding tax interest, Congress expected the IRS to promulgate regulations specifying circumstances where it might be necessary to reverse the priority of the look-through rule in order to forestall abuse of the separate basket rules, as described above.

Under the high-tax kick-out of section 904, the passive income basket generally excludes high-taxed income, that is, income subject to foreign taxes paid or deemed paid by the taxpayer at rates higher than the maximum federal rates. As with financial services income and shipping income discussed above, the Act provides that for purposes of applying the dividend look-through rule, income that would otherwise be passive basket income will instead go into the overall limitation basket if shown to be subject to an effective foreign tax rate greater than 90 percent of the maximum federal tax rate.

In the case of payments of interest, rents, and royalties to the U.S. shareholder out of income of a controlled foreign corporation that would otherwise be passive, the combined effect of the look-through and high-tax kick-out rules may have been unclear.

De minimis exception

If a controlled foreign corporation has no foreign base company income or subpart F insurance income in a taxable year because the subpart F de minimis rule (Code sec. 954(b)(3)(A), as amended by the Act) is satisfied for that year, then interest, rents, or royalties paid by the corporation during that year and dividends, to the extent treated as paid from that year's earnings and profits, are not treated as income in a separate limitation category.

Explanation of Provision

Payments by controlled foreign corporations to U.S. shareholders

The bill clarifies the Act's general rule that income of a U.S. shareholder allocable to separate category income of a controlled foreign corporation will retain that character in the hands of the U.S. shareholder, subject to the high-tax kick-out (and to another exception, described above, relating to interest paid by a controlled foreign corporation bearing a high withholding tax but attributable to financial services income). For example, the bill makes it explicit that interest that technically may qualify as export financing interest paid by a controlled foreign corporation to a U.S. shareholder out of the corporation's passive income will be in the shareholder's passive basket rather than its overall basket.

The bill makes it clear that the high-tax kick-out applies only at the U.S. shareholder level, not at the controlled foreign corporation level. Income of the U.S. shareholder out of the controlled foreign corporation's passive income will be subject to the kick-out based on the entire amount of foreign tax imposed on the U.S. shareholder's income. Thus, where a withholding tax is imposed on royalties paid by a controlled foreign corporation to a U.S. shareholder out of the corporation's passive income, the sharholder's income will be in the overall basket if the withholding tax is high enough to trigger the high-tax kick-out after allocation of U.S.-borne expenses.

De minimis exception

The bill limits the effect of the provision that treats income satisfying the de minimis rule as non-separate limitation income. Under the bill, this treatment applies only to the controlled foreign corporation's foreign base company income (determined without regard to deductions otherwise taken into account for subpart F purposes under sec. 954(b)(5)) and gross insurance income for the taxable year, as that term is generally used for subpart F purposes.

7. Deemed-paid credit

Present Law

Separate deemed paid foreign tax credit limitations

The Act clarifies that the rules for credits deemed paid on the receipt of dividends (Code sec. 902) and the subpart F deemed-paid credit rules (sec. 960), as well as the general foreign tax credit limitation rules (sec. 904(a)–(c)) and the separate foreign oil and gas limitation rules (sec. 907), apply separately to categories of income subject to the separate limitations. The Act also gives the Secretary authority to provide such regulations as may be necessary or appropriate to carry out both sets of deemed-paid credit rules, but in so doing, refers to specific authority to regulate the separate computation of taxes deemed paid on separate limitation categories of income only in the case of taxes deemed paid on account of dividends.

Fresh start for computing discounted unpaid losses

The Act provides that for purposes of computing the deemed-paid foreign tax credit, dividends or subpart F inclusions are considered made first from the post-1986 pool of all the distributing corporation's accumulated earnings and profits. Act amendments to subchapter L of the Code that limit the unpaid loss deductions of property and casualty insurance companies to the amount of their discounted unpaid losses (new sec. 846 of the Code) may result in a one-time increase in earnings for such a company.

In general, the new discounting provisions apply to taxable years beginning after December 31, 1986. A fresh start is provided with respect to undiscounted loss reserves applicable to the last taxable year beginning before January 1, 1987. Under this fresh start rule, the difference between the amount of undiscounted loss reserves and the discounted balances is not taken into income. For purposes of calculating any adjustment to earnings and profits, by contrast, the fresh start adjustment is to be taken into account in full in the first taxable year to which the discounting provisions apply.

Blocked income

In the case of taxes deemed paid under section 902 on dividends, the Act defines the term "post-1986 undistributed earnings" by reference to the definitions of earnings and profits in sections 964 (prescribing rules for the computation of earnings and profits of a foreign corporation) and 986 (prescribing rules for the translation of a foreign corporation's foreign currency denominated earnings into dollars).

Section 964 has 3 parts. The first part provides generally for the computation of earnings of foreign corporations in a way substantially similar to the earnings of a domestic corporation, with some exceptions. The second part excludes blocked income, for purposes of Code sections 952, 955, and 956, from earnings and profits of a controlled foreign corporation. Blocked income is income that is shown, to the satisfaction of the Secretary of the Treasury, to be unavailable for distribution by a controlled foreign corporation to United States shareholders due to currency or other restrictions or limitations imposed under the laws of any foreign country. The third part provides record-keeping and record disclosure rules for purposes of enforcing subpart F and subpart G (relating to export trade corporations).

Explanation of Provision

Separate deemed paid foreign tax credit limitations

The bill clarifies that the Secretary's authority to provide regulations to carry out the provisions of the subpart F deemed-paid credit rules is to include authority to provide for, inter alia, separate computations of taxes deemed paid upon inclusions under subpart F (as well as separate computations of taxes deemed paid in connection with dividends) to reflect the separate limitations applicable to separate types of income and loss.

Fresh start for computing discounted unpaid losses

The bill provides that any increase in earnings and profits under the discounting fresh start provision of the Act would be phased in ratably over 10 years for purposes of computing the post-1986 undistributed earnings of a foreign corporation paying dividends, or earning income, that bring up to its shareholders deemed-paid foreign tax credits. Thus, the one-time increase in current earnings and profits of a controlled foreign corporation under the discounting fresh start provision will not result in a sudden dilution of creditable foreign taxes as a percentage of dividends and subpart F inclusions.

Blocked income

The bill provides that for purposes of the deemed-paid credit on dividends, "post-1986 undistributed earnings" of a foreign corporation are computed without reference to the blocked income rules. Thus, the bill clarifies that the percentage of foreign taxes brought up by a dividend is unaffected by the portion of earnings, if any, that represent blocked income.

8. Recapture of foreign separate limitation losses

Present Law

The 1986 Act provided express rules to clarify that losses in the new and existing separate limitation baskets do not reduce U.S. taxable income before foreign taxable income (new Code sec. 904(f)(5)). The new rules provide that losses for any taxable year in a separate foreign tax credit limitation basket and in the overall limitation basket offset U.S. source income only to the extent that the aggregate amount of such losses exceeds the aggregate amount of foreign income earned in other baskets. These losses (to the extent that they do not exceed foreign income for the year) are to be allocated on a proportionate basis among (and operate to reduce) the foreign income baskets in which the entity earns income in the loss year.

By analogy to the overall foreign extraction loss recapture rules of section 907(c)(4), the Act further provides a loss recharacterization rule that applies to subsequent income. Where a basket previously showed a separate limitation loss which was allocated against income in other baskets, subsequent income in the loss basket will be recharacterized as income of the type that it previously offset, in proportion to the prior loss allocation not previously taken into account under this recharacterization provision.

In addition to the Act's new separate basket loss recapture provision and the overall foreign extraction loss recapture rules upon which the former is based, the Code provides a third rule, in effect since 1976, for recapture of overall foreign losses. This rule is designed to prevent taxpayers from benefiting from a combination of forgiveness of U.S. tax on a portion of current U.S. income (resulting from the use of an overall foreign loss to reduce worldwide taxable income below U.S. taxable income) and an allowance of a foreign tax credit with respect to the full amount of subsequent years' foreign income. Under the rule, a portion of foreign taxable income earned after an overall foreign loss year is treated as U.S. taxable income for foreign tax credit purposes (Code sec. 904(f)(1)-(4)).

Section 904(f)(3) contains gain recognition and characterization rules to ensure the recapture of an overall foreign loss where property which was used in a trade or business, and which was used predominantly outside of the United States, is disposed of prior to the time the loss has been recaptured by recharacterizing foreign income as U.S. taxable income. Under section 904(f)(3), gain on such a disposition is viewed as foreign source income to be recharacterized as U.S. source income until the loss is fully recaptured. Recapture occurs regardless of whether gain would otherwise have been recognized on the disposition. There is no provision analogous to section 904(f)(3) in the recapture rules for foreign oil and gas extraction losses, or in the Act's new separate limitation loss recapture provision.

Explanation of Provision

The bill adds a provision to the Act's separate loss recharacterization rules stating that recognition rules similar to those of 904(f)(3), applicable to an overall foreign loss, shall apply to any disposition of property, the gain from which would be in an income category whose separate limitation loss was allocated against any separate limitation income. Thus, the bill achieves a result consistent with the general loss recharacterization rules of the Act in the case where losses in a category have been allocated against income in the other categories, and property generating income in the loss category is disposed of at a gain (whether or not the gain would be recognized for other Code purposes) before income in the other categories has been restored to the full extent of losses allocated gainst them.

9. Transitional rule for excess credit carryforwards

Present Law

Under the Act, foreign tax credit carryforwards allowed for foreign taxes paid in pre-effective date tax years (that is, years beginning before 1987, to which the Act amendments to the foreign tax credit rules generally do not apply) generally reduce the U.S. tax in post-effective date years (that is, years beginning after 1986) on income of the same limitation type as the income on which the carried forward taxes were imposed. For example, the Act provides that foreign tax credit carryforwards of foreign taxes paid in pre-effective date taxable years on income then subject to the overall limitation generally are to reduce the U.S. tax in post-effective date taxable years on overall limitation income as newly defined by the Act. Similarly, carryforwards from the prior law basket for interest are to reduce U.S. tax on post-effective date passive income.

However, the Act provides that pre-effective date excess credits for taxes on overall limitation income can be carried to post-effective date years to reduce the U.S. tax on shipping income to the extent that the taxpayer establishes to the satisfaction of the Secretary that the overall limitation income on which the taxes were paid would have been classified as shipping income had it been earned after the Act's effective date. Similarly, in the case of an entity predominantly engaged (in both the carry-from and carry-to years) in the active conduct of a banking, insurance, financing, or similar business the Act provides that pre-effective date excess credits for taxes on overall limitation income can be carried to post-effective date years to reduce the U.S. tax on financial services income to the extent that the taxpayer establishes to the satisfaction of the Secretary that the overall limitation income on which the taxes were paid would have been classified as financial services income had it been earned after the Act's effective date.

Explanation of Provisions

The bill provides that pre-effective date excess credits for taxes on overall limitation income can be carried to post-effective date years to reduce the U.S. tax on high withholding tax income to the extent that the taxpayer chooses to and does establish to the satisfaction of the Secretary that the overall limitation income on which the taxes were paid would have been classified as high withholding tax income under the Act's substantive rules (that is, under the Act without regard to the transitional rule for qualified loans, discussed above). For example, a gross basis tax of 5 percent or more, paid by a bank in a pre-effective date year on interest earned in the conduct of its banking business, could be carried forward to reduce residual U.S. taxes (if any) on its post-effective date high withholding tax interest, rather than taxes on income in the overall basket. As another example, the bill would enable a manufacturer with excess post-effective date credits on its foreign manufacturing income, but excess limitation on its high withholding tax interest, to use credit carryforwards for 5 percent or more gross-basis taxes paid on pre-effective date overall basket interest to offset the residual U.S. tax on post-effective date high withholding tax interest.

B. Source Rules

1. Determination of source in case of sales of personal property (sec. 6774(d) of the bill, sec. 1211 of the Reform Act, and secs. 864 and 865 of the Code)

Present Law

Overview

Prior to the Act, the source of income derived from the sale of personal property generally was determined by the place of sale (commonly referred to as the "title passage" rule). While the Act did not change the place-of-sale rule for most inventory sales, the Act generally did replace the place-of-sale rule for sales of other personal property with a residence-of-the-seller rule.

Under the residence-of-the-seller rule (new sec. 865), income derived by U.S. residents from the sale of personal property, tangible or intangible, generally is sourced in the United States. Similarly, income derived by a nonresident of the United States from the sale of personal property, tangible or intangible, generally is treated as foreign source. For purposes of determining source, the term sale does not include a sale of intangible property to the extent payments received in consideration for the sale are contingent on the productivity, use, or other disposition of the property. Payments that are so contingent are treated like royalties in determining their source.

Definition of resident

The Act provided new definitions of a U.S. resident and nonresident for source rule purposes (sec. 865) that differ somewhat from the existing resident alien definitions (*see, e.g.*, sec. 770(b)). An individual is a resident of the United States for purposes of section 865 if the individual has a tax home (as defined in sec. 911(d)(3)) in the United States. Any corporation, partnership, trust, or estate which is a United States person (as defined in sec. 7701(a)(30)) is a U.S. resident for this purpose. Other individuals and entities generally are nonresidents for purposes of these source rules. A U.S. citizen or resident alien can be treated as a nonresident for purposes of these source rules if he or she has a tax home outside the United States. The same individual can also be treated as a nonresident if he or she has no tax home (a condition that might be possible, for example, in the case of a traveling salesperson). This latter result may occur even if the individual pays only a minimal foreign tax on income covered by these source rules.

Under the Act, regulations are to be prescribed by the Secretary carrying out the purposes of the Act's source rule provisions. One area where it was contemplated that regulations may be required is to prevent persons from establishing partnerships or corporations, for example, to change their residence to take advantage of the new rules. It was anticipated that the establishment of an anti-abuse rule to treat, for example, a foreign partnership as a U.S. resident to the extent its partners are U.S. persons would be appropriate.

United States citizens and resident aliens who have tax homes outside the United States are nevertheless considered U.S. residents in one case. This case occurs when income from a sale is not subject to an effective foreign income tax of 10 percent or more. This level-of-tax rule prevents U.S. citizens and resident aliens from generating zero- or low-taxed foreign source income that might otherwise escape all tax. As a consequence of retaining prior law's place-of-sale rule for income derived from the sale of inventory and gain in excess of recapture derived from the sale of depreciable personal property, the level-of-tax rule does not apply to sales of those types of personal property but does apply to sales of all other types of personal property.

Exceptions to residence rule

Income derived from the sale of depreciable personal property

The residence-of-the-seller rule does not apply to income derived from the sale of depreciable personal property, to the extent of prior depreciation deductions. This income is sourced under a recapture principle. Specifically, gain to the extent of prior depreciation deductions from the sale of depreciable personal property is sourced in the United States if the depreciation deductions giving rise to the gain were previously allocated against U.S. source income. If the deductions giving rise to the gain were previously allocated against foreign source income, gain from the sale (to the extent of prior deductions) is sourced foreign. If personal property is used predominantly in the United States for any taxable year, the taxpayer is to treat the allowable deductions for the year as being allocable entirely against U.S. source income. If personal property is used predominantly outside the United States for any taxable year, the taxpayer is to treat the allowable deductions for such year as being allocable entirely against foreign source income. (This special predominant-use rule does not apply for certain personal property generally used outside the United States, namely, personal property described in sec. 48(a)(2)(B).) These rules apply without regard to the residence of the taxpayer.

Depreciable personal property is any personal property if the adjusted basis of the property includes depreciation adjustments. Thus, intangible property for which an amortization deduction is allowable is considered depreciable personal property. With respect to sales of intangible property, however, it is unclear under the Act whether the recapture rule applies to gain to the extent of amortization recapture, and whether the general intangible rules or the place-of-sale rule as retained under the Act applies to gain in excess of amortization recapture.

Income attributable to an office or other fixed place of business

The residence-of-the-seller rule does not apply to income derived from the sale of personal property when the sale is attributable to an office or other fixed place of business outside the seller's residence.

For U.S. residents, this office rule applies to certain income derived from the sale of personal property when the sale is attributable to an office or other fixed place of business maintained by the taxpayer outside the United States but only if an effective foreign income tax of 10 percent or more is paid to a foreign country on the income from the sale. It is unclear under the Act if the office rule applies to income (in the form of noncontingent payments) derived from the sale of intangible property by a U.S. resident when the sale is attributable to a fixed place of business in a foreign country and the U.S. resident pays an income tax at an effective rate of 10 percent or more.

Income derived from the sale of stock in foreign affiliates

The residence-of-the-seller rule does not apply to income derived by U.S. corporations from the sale of stock in certain foreign affiliates. If a U.S. corporation sells stock of a foreign affiliate in the foreign country in which the affiliate derived from the active conduct of a trade or business more than 50 percent of its gross income for the 3-year period ending with the close of the affiliate's taxable year immediately preceding the year during which the sale occurs, any gain from the sale is foreign source. An affiliate, for this purpose, is any foreign corporation whose stock is at least 80 percent owned (by both voting power and value). It is unclear under the Act if this rule applies only to gain from the sale of stock in corporations directly engaged in an active trade or business or also applies to gain from the sale of stock in corporations indirectly engaged in an active trade or business (for example, through a locally incorporated subsidiary).

Other rules

Prior to the Act, foreign source income derived from the sale of inventory property by a foreign person generally was treated as effectively connected with the conduct of a U.S. trade or business if the sale was attributable to a U.S. office (or other fixed place of business) and sold through the U.S. office. The Act repealed this rule but generally made income derived from the sale of any personal property (including inventory property) by a nonresident (as defined in section 865 for personal property source rule purposes) U.S. source when the sale is attributable to a U.S. office (or other fixed place of business). Because the Act also generally retains the place-of-sale rule for sales of inventory property by residents (as defined in section 865), the repeal of the effectively connected rule would allow residents who are treated for general purposes (outside section 865) as nonresident aliens to avoid U.S. tax on income attributable to a U.S. office by placing sales of inventory property outside the United States.

The Act's legislative history indicated that Congress intended that the Act's source rule changes prevail over treaty source rules for foreign tax credit limitation purposes to the extent necessary to insure that income not taxed by a foreign country not escape U.S. tax as well. This policy was to apply to all the source rule changes in the Act, not just those applicable to personal property. Although the Act and its legislative history did not specifically address cases where some foreign tax may be paid on income treated as U.S. source under the Act, application of the later-in-time principle would result in the Act's rules prevailing over any conflicting preexisting treaty provisions.

Treasury Department study

The Act directs the Treasury Department to study the effect of the title passage rule as it applies in determining the source of the imcome from the sale of inventory property. That study is to take into account the Act's lower tax rates and Congressional trade concerns. The study was due to be reported to the House Committee on Ways and Means and the Senate Committee on Finance not later than September 30, 1987.

Explanation of Provision

Definition of resident

The bill modifies the definition of resident for source rule purposes in the case of individuals and partnerships. First, the bill treats any U.S. citizen or resident alien as a U.S. resident if he or she does not have a tax home in a foreign country and, as under present law, it treats any nonresident alien as a U.S. resident if he or she has a tax home in the United States. A U.S. citizen or resident alien who has a tax home in a foreign country is treated as a nonresident for source rule purposes as is a nonresident alien who does not have a tax home in the United States.

Second, whereas the Act generally determined the source of income derived from sales of personal property by treating a partnership as a U.S. resident or nonresident based on its situs, the bill makes these determinations at the partner level, except as provided in regulations. In determining source, the committee intends that, consistent with the attribution of a U.S. trade or business under Code section 875, a U.S. office or other fixed place of business of the partnership will be attributed to its partners. Similarly, it is anticipated that a partnership's foreign office will be attributed to its partners as long as the office is considered a permanent establishment in the foreign country.

The bill provides regulatory authority to determine source at the partnership level, for example, in cases where it is not administratively possible to apply the rules at the partner level. For example, it may be appropriate to determine source at the partnership level in the case of a publicly traded partnership which has hundreds of partners.

The bill also modifies the 10-percent tax payment requirement (applicable to U.S. citizens and resident aliens maintaining tax homes in a foreign country) for bona fide residents of Puerto Rico. The 10-percent tax payment requirement is waived for an individual who is a bona fide resident of Puerto Rico for the entire taxable year on the sale of stock of a corporation which (directly or indirectly) (1) is engaged in an active trade or business in Puerto Rico, and (2) derives from the active conduct of a trade or business in Puerto Rico more than 50 percent of its gross income for the 3 years preceding the year of sale. Under this rule, bona fide residents of Puerto Rico who sell stock in certain corporations doing business in Puerto Rico generate Puerto Rican source income and, thus, retain the benefits of section 933.

Exceptions to residence rule

Income derived from the sale of intangibles

The bill clarifies that income to the extent of previously allowed amortization deductions derived from the sale of amortizable intangible property is sourced under the Act's recapture rule. The recapture rule applies whether or not the payments in consideration for the sale are contingent on the productivity, use, or disposition of the property. For sales where the payments are so contingent, the committee intends that the source of all payments will be determined under the recapture rule until the entire recapture amount has been recaptured, and that any remaining payments will be sourced under the general intangible rules.

The bill also clarifies that gain derived from the sale of intangible property in excess of amortization recapture is sourced under the residenc-of-the-seller rule when the payments in consideration for the sale are not contingent on the productivity, use, or disposition of the property. When payments are so contingent, the source rule for royalties applies to the gain.

Income attributable to an office or other fixed place of business

The bill clarifies that the office rule as it applies to U.S. persons also applies to a sale of intangible property when the payments in considertaion for the sale are not contingent on the productivity, use, or disposition of the property. Thus, a U.S. resident who sells intangible property for noncontingent payments generates foreign source income as long as the sale is attributable to a foreign office and an effective rate of foreign income tax of at least 10 percent is paid on the income derived from the sale.

The bill also modifies the office rule to conform with the Act's source rules governing space and ocean activities. This modification provides that the office rule applies to U.S. persons only if they maintain an office in a foreign country, rather than in the United States. The bill makes similar conforming amendments to the Act's other source rule provisions.

Income derived from the sale of stock in foreign affiliates

The bill clarifies that income derived from the sale of stock of a foreign affiliate which wholly owns another foreign corporation is treated as foreign source income in certain cases. Upon an election by the U.S. resident, as long as either the parent or the subsidiary is engaged in an active trade or business in the country in which the sale occurs and 50 percent of the gross income of the holding company and the subsidiary combined for a three-year period is derived from the active conduct of a trade or business in that foreign country, then gain on the sale of stock in the holding company will be treated as foreign source.

Other rules

The bill reinstates the provision repealed by the Act that treats foreign source income derived from certain sales of inventory property by a foreign person as effectively connected with the conduct of a U.S. trade or business. This provision is necessary to ensure that foreign persons who have a substantial presence in the United States, who may be treated as U.S. residents for source rule purposes but as nonresidents for general purposes, are taxed on income derived from sales of inventory property.

The bill codifies and expands upon the Act's legislative history by providing (in connection with the changes to sec. 7852(d)) that the Act's source rule changes generally prevail over any conflicting treaty source rules under the general later-in-time rule. The bill does provide, however, an exception to the general later-in-time rule. Under this exception, if a taxpayer, by claiming treaty benefits, treats as foreign source any gain derived from the sale of stock in a treaty country corporation or of an intangible which would be U.S. source under the Act, then foreign taxes on that gain cannot offset U.S. tax on any other item of income, and foreign taxes on any other item of income cannot offset U.S. tax on that gain. For example, under the Act, gain from the sale of stock in a less-than-80-percent owned foreign corporation by a U.S. resident is U.S. source. A treaty may treat that income as foreign source. Under the bill, that income is subject to U.S. tax as foreign source income, but the U.S. resident may credit only foreign tax imposed on that income against the U.S. tax imposed on that income.

Treasury Department study

The bill modifies the Act's directive to the Treasury Department on the study of the title passage rule. The modifications require the Treasury Department to conduct the study in conjunction with the Commerce Department and the United States Trade Representative and to complete the study not later than September 30, 1988.

2. Special rules for exemption from U.S. tax on U.S. source transportation income (sec. 6674(e) of the bill, sec. 1212 of the Reform Act, and secs. 872 and 883 of the Code)

Present Law

The Code's reciprocal exemption provisions sometimes exempt foreign persons from U.S. tax on U.S. source transportation income. Prior to the Act, the reciprocal exemption provisions exempted foreign persons from U.S. tax on earnings derived from the operation of ships (or aircraft) documented under the laws of a foreign country if that country exempted U.S. citizens and domestic corporations from its tax. The Act modified these provisions to provide the exemption from U.S. tax only to alien individuals who are residents of, and foreign corporations organized in, a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption.

A foreign corporation, in addition to having to be organized in a country that grants U.S. persons an equivalent exemption, must also satisfy a residence-based requirement to obtain U.S. tax exemption. Under the residence-based requirement, the ultimate individual owners of more than 50 percent of the value of the stock of the foreign corporation must be residents of a foreign country that grants U.S. citizens and domestic corporations an equivalent exemption. Thus, it is not enough for the foreign corporation to be organized in a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption: individuals ultimately owning most of its stock must reside in such a country as well. Ultimate individual ownership is determined by treating stock owned directly or indirectly by or for any entity (for example, a corporation, partnership, or trust) as being actually owned by the stockholder (or partner, grantor, or beneficiary, as the case may be) of that entity and by further attributing that ownership to its owners if necessary to reach individual owners.

The residence-based requirement does not apply to any foreign corporation organized in a foreign country that exempts U.S. persons from its tax if the stock of the corporation is primarily and regularly traded on an established securities market in that foreign country. This publicly traded exception also covers a foreign corporation that is wholly owned by a second corporation organized in the same country as the first foreign corporation if the stock of the second foreign corporation is primarily and regularly traded on an established securities market in that country.

Explanation of Provision

The bill modifies the reciprocal exemption provisions so that they operate independently with respect to nonresident alien individuals and foreign corporations. Thus, for a nonresident alien individual to be exempt from U.S. tax, his or her country of residence need exempt only U.S. citizens from its tax. Similarly, for a foreign corporation to be exempt from U.S. tax, its country of organization need exempt only U.S. corporations from that country's tax.

The bill modifies the publicly-traded exception to the residence-based requirement. This modification provides that if a foreign corporation is organized in a country which exempts U.S. corporations from that country's tax and the foreign corporation's stock is primarily and regularly traded on an established securities market in that country, then any stock owned by that corporation in another foreign corporation that is organized in a foreign country which exempts U.S. corporations from that country's tax shall be treated as owned by individuals who are resident in the country in which the corporate shareholder is organized. Thus, for example, if four foreign corporations own all the stock of another foreign corporation, all five corporations are organized in countries which exempt U.S. corporations from their tax, and the stock of the first four corporations is primarily and regularly traded on established securities markets in their respective countries, then the stock of each of the four corporations shall be treated as owned by individuals resident in the four corporations' respective countries of organization. Since more than 50 percent of the value of the stock of the fifth corporation is considered owned by residents of countries which exempt U.S. persons from their tax, the fifth corporation is eligible under the bill for the reciprocal exemption.

3. Source rule for space and certain ocean activities (sec. 6674(f) of the bill, sec. 1213 of the Reform Act, and sec. 863 of the Code)

Present Law

The Act enacted source rules for activities conducted in space, on or beneath the ocean, and on Antarctica. In defining the term "space or ocean activity", the Act excluded an activity giving rise to international communications income. The Act defined international communications income to include all income derived from the transmission of communications or data from the United States to any foreign country or from any foreign country to the United States. The Act did not define foreign country for this purpose.

Explanation of Provision

The bill modifies the definition of international communications income to include all income derived from the transmission of communications or data from the United States to any possession of the United States (and vice-versa) as well as to any foreign country.

4. Limitations on special treatment of 80/20 corporations (sec. 6674(g) of the bill, sec. 1214 of the Reform Act, and secs. 861, 864, 907 and 2105 of the Code)

Present Law

Prior to the Act, a U.S. corporation's dividend and interest payments were foreign source and not subject to U.S. withholding tax when at least 80 percent of the U.S. corporation's income over the prior three years was from foreign sources (this type of corporation was commonly referred to as an 80/20 company). The Act repealed prior law as it applied to dividends paid by an 80/20 company (other than dividends paid by a possessions corporation) and treats dividends paid by U.S. corporations as U.S. source. Dividends received by foreign persons from U.S. corporations, though treated as U.S. source, receive look-through treatment for U.S. withholding tax purposes when the corporation satisfies an active foreign business requirement. In such a case, the amount of the withholding tax exemption is based on the source of the income earned by the U.S. corporation. With respect to interest payments by a U.S. corporation, the Act generally treats the interest as U.S. source unless the corporation satisfies the active foreign business requirement. If the active foreign business requirement is met, the Act treats interest paid by a U.S. corporation as foreign source if the interest is paid to an unrelated party and as having a prorated source based on the source of the payor's income if the interest is paid to a related party.

The active foreign business requirement is satisfied if at least 80 percent of the U.S. corporation's gross income for the 3-year period preceding the year of the payment is derived from foreign sources and is attributable to the active conduct of a trade or business in one or more foreign jurisdictions (or U.S. possessions).

The 80-percent active foreign business requirement may be met by the U.S. corporation alone or, instead, may be met by a group including domestic or foreign subsidiaries in which the U.S. corporation owns a controlling interest. It is intended that at least a 50-percent ownership interest be required for a subsidiary's business to be attributed to a U.S. shareholder. In allowing attribution of a subsidiary's active foreign business to a controlling corporate shareholder, the character (i.e., active foreign business income) of the subsidiary's gross income is intended to be attributed to the corporate shareholder only on the actual inclusion of income from the subsidary, for example, dividends, interest, rents, or royalties, and for the purpose of determining the percentage of dividends paid by the shareholder that are subject to U.S. withholding tax. Thus, for example, dividends received by a corporate shareholder from controlled U.S. subsidiaries, though treated as U.S. source in the hands of the corporate shareholder, are to be characterized as active foreign business income for the purpose of this look-through rule in the same proportion that the controlled subsidiaries' active foreign business income bears to their total income. With respect to other items of income received from controlled subsidiaries, those amounts are to be characterized as active foreign business income to the extent they are allocated against active foreign business income of the payor.

Prior to the Act, certain income paid by U.S. persons to foreign persons was effectively exempted from U.S. withholding tax because the income was treated as foreign source income. Under the Act, the income is treated as U.S. source, but the exemption from U.S. withholding tax is made explicit. The interest affected includes interest on deposits with persons carrying on the banking business, interest on deposits or withdrawable accounts with a Federal or State chartered savings institution as long as such interest is a deductible expense to the savings institution under section 591, and interest on amounts held by an insurance company under an agreement to pay interest thereon, but, in each case, only if such interest is not effectively connected with the conduct of a trade or business within the United States by the recipient of the interest. The Act also made an explicit exemption from U.S. withholding tax for income derived by a foreign central bank of issue from bankers' acceptances. By treating the interest on deposits as U.S. source, it is not intended that the principal amounts which generate the income be includible in a foreign person's estate.

Explanation of Provision

The bill clarifies that, for purposes of attributing a lower-tier corporation's active foreign business income to an upper-tier U.S. corporation, the upper-tier corporation must own directly or indirectly at least 50 percent of both the voting power and value of the stock of the lower-tier corporation.

The bill also clarifies that, for purposes of attributing a lower-tier corporation's active foreign business income to an upper-tier U.S. corporation, the source of the lower-tier corporation's income, as well as its character, is attributed to the upper-tier corporation. Thus, for example, if an upper-tier U.S. corporation receives a dividend from a qualifying lower-tier U.S. corporation, the dividend shall, for purposes of determining whether any withholding tax will be imposed on the upper-tier corporation's dividend distributions, be considered as having both the character and the source of the lower-tier corporation's income. For foreign tax credit purposes, the dividend from the lower-tier corporation is U.S. source, however.

The bill clarifies that the change is source for certain interest on deposits does not change its treatment for estate tax purposes. Thus, for example, bank deposits the interest on which is not effectively connected with a U.S. trade or business, though such interest is treated as U.S. source income, are not treated as property within the United States.

Further, the bill clarifies that the Act's provisions are generally effective for payments made in taxable years of the payor beginning after December 31, 1986.

5. Rules for allocation of interest, etc., to foreign source income (sec 6674(h) of the bill, sec. 1215 of the Reform Act, and sec. 864(e) of the Code)

Present Law

Basis of stock of nonaffiliated 10-percent owned corporation

When the tax book value method of expense apportionment is used, the Act provides a new rule to allocate and apportion expenses on the basis of assets when the asset is stock in one of certain corporations. If a 10-percent or more owned corporation is not included in the group treated as one taxpayer, then, in general, the adjusted basis of the stock owned in such corporation in the hands of a U.S. shareholder is increased by the amount of the earnings and profits of the corporation attributable to that stock and accumulated during the period the taxpayer held it. Earnings and profits are not limited to those accumulated in post-enactment years. (In general, two kinds of 10-percent owned corporations are not included in the one-taxpayer group: foreign corporations, and U.S. corporations that are more than 10- but less than 80-percent owned.) In the case of a deficit in earnings and profits of the corporation that arose during the period when the U.S. shareholder held the stock, that deficit reduces the adjusted basis of the asset in the hands of the shareholder. In that case, however, the deficit cannot reduce the adjusted basis of the asset below zero.

Under prior law and under the Act, subpart F inclusions increase stock basis in but do not decrease earnings and profits of a controlled foreign corporation (secs. 961 and 959). Congress did not intend that the addition of such amounts to stock basis by virtue of a subpart F inclusion (or another inclusion with an equivalent effect on basis) result in double counting.

Allocation of expenses to deductible dividends

The Act provides that for purposes of allocating or apportioning any deductible expense, any tax-exempt asset (and any income from such an asset) shall not be taken into account. A similar rule applies in the case of any dividend from a U.S. corporation that is eligible under section 243 for the 80-percent dividends received deduction (but not in the case of a dividend from a U.S. corporation that is eligible for the 100-percent dividends received deduction) and in the case of any dividend from a foreign corporation a fraction of which (that reflects its U.S. earnings) is eligible under section 245(a) for an 80-percent dividends received deduction.

Treatment of bank holding companies and banks

While the Act generally requires an affiliated group to be treated as if all members of the group were one taxpayer for purposes of allocating and apportioning interest expense, that general rule does not apply to any financial institution (described in section 581 or 591) if the business of the financial institution is predominantly with persons other than related persons or their customers, and if the financial institution is required by State or Federal law to be operated separately from any other entity which is not a financial institution. A bank to which this exception applies is not treated as a member of the group for applying the Act's general one-taxpayer rule for interest expense allocation and apportionment to other members of the group; instead, that bank and all other banks in the group are to be treated as one taxpayer (rather than each bank being treated as a separate taxpayer for this purpose).

Although treated separately from other group members for interest expense allocation, banks were to be treated as part of the overall group that the Act treats as one taxpayer for expenses other than interest. The Act does not make this distinction.

Direct allocation of interest expense when deduction is denied

The Act provides that the Secretary is to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations providing for direct allocation of interest expense incurred to carry out an integrated financial transaction to any interest (or interest-type income) derived from such transaction.

In certain cases, the dividends received deduction is reduced in cases where portfolio stock is debt financed (Code sec. 246A). In addition, a life insurance company is allowed a dividends received deduction for its share of dividends received, but this deduction is not allowed for the policyholders' share of dividends received. Further, the reserve deduction and other deductible payments to policyholders of a life insurance company are reduced by the policyholders' share of tax exempt interest. Moreover, in the case of a property and casualty insurance company, 15 percent of the sum of tax exempt interest and the deductible portion of dividends received reduces the deduction for losses incurred (sec. 832(b) (4)).

Scope of expense allocation rules

For purposes of subchapter N of chapter 1 of the Code (secs. 861-999), except as provided in regulations, the Act provides a series of rules governing expense allocation and apportionment. The intent of the grant of regulatory authority was to allow regulations to identify provisions of this subchapter to which the new rules would not apply. The Act's rules literally apply for the determination of taxable income from sources outside the United States. With one exception, however, these rules were intended to apply for all determinations under subchapter N of chapter 1, whatever the source (U.S. or foreign) of the income against which expenses are allocated. The exception relates to the possessions tax credit: Congress did not intend that new Code section 864(e)(1) apply for purposes of computations under section 936(h).

Transition rules

The Act provides a number of transition rules designed to phase in the application of the new expense allocation rules insofar as they relate to interest expenses.

Explanation of Provisions

Basis of stock of nonaffiliated 10-percent owned corporations

The bill clarifies the Act's rule governing the allocation and apportionment of expenses when the tax book value method is used and the asset at issue is stock in one of certain corporations. The adjusted basis of any stock in a nonaffiliated 10-percent owned corporation is increased by the amount of earnings and profits of that corporation attributable to that stock and accumulated during the period the taxpayer held the stock, or reduced, but not below zero, by any deficits in earnings and profits in that corporation attributable to that stock for that period. For this purpose, a "nonaffiliated 10-percent owned corporation" is one that is not included in the taxpayer's affiliated group, and in which members of the affiliated group own 10 percent or more of the voting power. The bill makes it clear that the adjustment to asset value on a look-through basis is also applied to stock of foreign corporations that is not directly held by U.S. taxpayers but that is indirectly 10-percent owned by U.S. taxpayers. Stock owned directly or indirectly by a corporation, partnership, or trust is treated as being owned proportionately by its shareholders, partners or beneficiaries. When a taxpayer is treated under this look-through rule as owning stock in a lower-tier corporation, the adjustment to the basis of the upper-tier corporation in which the taxpayer actually owns stock is to include an adjustment for the amount of the earnings and profits (or deficit in earnings and profits) of the lower-tier corporation which were attributable to the stock the taxpayer is treated as owning and to the period during which the taxpayer is treated as owning that stock.

The bill provides that, for purposes of section 864(e), proper adjustment is to be made to the earnings and profits of any corporation to take into account any earnings and profits included in gross income under the subpart F current inclusion rules (or under any other provision) that are reflected in the adjusted basis of the stock. Thus, a subpart F inclusion, which increases stock basis but does not decrease earnings and profits of a controlled foreign corporation, is not to result in double counting.

Allocation of expenses to deductible dividends

The bill makes it clear that to the extent any dividend benefits from the dividends received deduction under section 243 (allowing an 80-percent dividends received deduction for certain dividends from U.S. corporations) or 245(a) (allowing an 80-percent dividends received deduction for the U.S. source portion of certain dividends from foreign corporations), that portion of the dividend is treated as tax exempt income for the purpose of the Act's expense allocation rules and that portion of the related asset is treated as a tax exempt asset.

Treatment of bank holding companies and banks

The bill provides that, to the extent provided in regulations, a bank holding company (within the meaning of section 2(a) of the Bank Holding Company act of 1956), and any subsidiary of a bank holding company (or of a financial institution described in section 581 or 591) that is predominantly engaged (directly or indirectly) in the active conduct of a banking, financing, or similar business, shall be treated as a financial institution for purposes of the exception that applies in certain cases to financial institutions described in section 581 to 591. The bill also makes it clear that any financial institution that is excluded from the general one-taxpayer group and is included in a one-taxpayer group covering financial institutions is not so treated for purposes of expenses other than interest. That is, financial institutions and all other affiliated entities are treated as one taxpayer under the Act for expenses other than interest.

Direct allocation of interest expense when deduction is denied

The bill provides that the Secretary is to prescribe regulations for direct allocation of interest expense in the case of indebtedness resulting in a disallowance under section 246A, which reduces the dividends received deduction in cases where portfolio stock is debt financed. Thus, to the extent that an interest deduction reduces the amount of the dividends received deduction, the interest expense generating the loss of the dividends received deduction is to be treated as directly allocable to the income resulting from the loss of the dividends received deduction.

Under the bill, the Secretary is also to prescribe regulations providing that, in the case of a life insurance company, the Act's rule requiring that tax-exempt assets and income therefrom be disregarded will not apply to the policyholders' share of any tax-exempt asset or income from such an asset. That is, the policyholders' share of assets that produce tax-exempt income will attract expenses notwithstanding their tax-exempt character. The same treatment applies to tax-exempt assets of property and casualty insurance companies, to the extent that the income from such assets reduces that company's loss deduction (under section 832(b)(4)).

In general, similar treatment is to apply with respect to the policyholder's share of stock that insurance companies hold to the extent that dividends it pays would be eligible for the 80-percent dividends received deduction. Thus, that stock will attract expenses notwithstanding the deduction for the dividends it would pay.

Scope of expense allocation rules

The bill provides that new Code section 864(e) (relating to expense allocation) shall not apply for purposes of any provision of subchapter N of chapter 1 of the Code (secs. 861-999) to the extent the Secretary determines under regulations that the application of this subsection for such purposes would not be appropriate. In a conforming amendment, the bill deletes the provision for exceptions to new Code section 864(e) in the introductory language to that subsection.

With one exception, the bill makes it clear that these rules apply for all determinations under subchapter N of chapter 1, whatever the source of the income against which expenses are allocated. The exception relates to the possessions tax credit: Code section 936(h) is to apply as if new Code section 864(e)(1) had not been enacted.

Transition rules

The bill clarifies the operation of the Act's transition rules.

One set of the bill's provisions clarifies the Act's phase-in of the Act's new rules governing interest expense allocation generally. (This set of the bill's provisions does not affect the Act's phase-in of the one-taxpayer rule of new Code sec. 864(e)(1), which is described below.) These clarifications, the bill's "general" phase-in provisions, apply to the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985. In the case of the first three taxable years of the taxpayer beginning after December 31, 1986, the Act's amendments relating to interest expense allocation (other than the one-taxpayer rule of new Code sec. 864(e)(1)) do not apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness which does not exceed the general phase-in amount. Except for certain reductions in indebtedness, the consequences of which are described below, the general phase-in amount is the applicable percentage of the taxpayer's debt outstanding on November 16, 1985. In the case of the first taxable year, the applicable percentage is 75; in the case of the second taxable year, the applicable percentage is 50; in the case of the third taxable year, the applicable percentage is 25.

The general phase-in amount eligible for relief for any period, however, is not to exceed the lowest amount of indebtedness of the taxpayer outstanding as of the close of any preceding month beginning after November 16, 1985. This limitation is designed to implement the Act's intent to target transitional relief to corporate groups that had borrowed in reliance on prior law and to deny transitional relief to the extent that the level of debt increases. To the extent provided in regulations, the average amount of indebtedness outstanding during any month is to be used in lieu of the amount outstanding as of the close of such month for this purpose. This grant of regulatory authority is designed to allow the Internal Revenue Service to disallow transition relief to taxpayers whose month-end debt levels are not representative of their monthly debt levels generally. Reductions in debt as of a month's end are not to reduce phase-in relief for prior months, however. For example, if a calendar year taxpayer's outstanding debt is $100 on November 16, 1985 and at all times thereafter until December 1, 1987, at which time it pays off all its debt, the taxpayer is entitled to general phase-in treatment for interest on $75 during the first 11 months of 1987.

In addition, the bill's "special" phase-in rules clarify the Act's provisions that phase in the Act's one-taxpayer rule (new Code sec. 864(e)(1)). In the case of the taxpayer's first five taxable years beginning after December 31, 1986, the Code's new one-taxpayer rule (Code sec. 864(e)(1)) is not to apply to interest expenses paid or accrued by the taxpayer during the taxable year with respect to an aggregate amount of indebtedness that does not exceed the special phase-in amount. The special phase-in amount is generally the sum of three separae amounts: the general phase-in amount, described above, the five-year phase-in amount, and the four-year phase-in amount. The special phase-in amount, however, like the general phase-in amount, cannot exceed the lowest amount of indebtedness of the taxpayer outstanding as of the close of any preceding month beginning after November 16, 1985.

The five-year phase-in amount is the lesser of two amounts. The first amount is an applicable percentage of the"5-year base." The 5-year base is the excess (if any) of the amount of a taxpayer's outstanding indebtedness on May 29, 1985, over the amount of the taxpayer's outstanding indebtedness as of the close of December 31,

1983. For this purpose, however, the 5-year base cannot exceed the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985. The applicable percentage, in each year, is the excess of the percentage granted relief under the Act's 5-year phase-in over the percentage granted relief under the Act's general (3-year) phase-in. In the case of the first taxable year beginning after December 31, 1986, the applicable percentage is 8⅓ (83⅓–75); in the case of the second taxable year, the applicable percentage is 16⅔ (66⅔–50); in the case of the third taxable year, the applicable percentage is 25 (50–25); in the case of the fourth taxable year, the applicable percentage is 33⅓; and in the case of the fifth taxable year, the applicable percentage is 16⅔.

The 5-year phase-in amount cannot exceed a second amount. That second amount, which is in the nature of a limitation, caps the 5-year phase-in amount in cases where reductions of indebtedness ("paydowns") reduce the taxpayer's debt below the amount that would have been eligible for 5-year relief had no paydown occurred. More specifically, the second amount is the 5-year base, reduced (but not below zero) by paydowns of debt, and then multiplied by a percentage. The paydowns that reduce the 5-year base for this purpose are defined as the excess of the taxpayer's November purpose are defined as the excess of the taxpayer's November 16, 1985, debt over the lowest amount of indebtedness of the taxpayer outstanding as of the close of any preceding month beginning after November 16, 1985 (or to the extent provided in regulations, as under the general phase-in, the average amount of indebtedness outstanding during any such month).

To compute this second amount, the (possibly reduced) 5-year base is multiplied by a fraction the numerator of which is the applicable 5-year percentage (the excess of the 5-year percentage under present law over the 3-year percentage), and the denominator of which is the sum of the applicable percentage under the general (3-year) rule and the applicable percentage under the 5-year rule. This second amount limits the 5-year base below the amount of relief that would be granted if no paydown had occurred. In the case of the first taxable year beginning after December 31, 1986, this percentage is 10, *i.e.*, 8⅓ divided by the sum of 8⅓ and 75; in the case of the second taxable year, this percentage is 25, *i.e.*, 16⅔ divided by the sum of 50 and 16⅔; in the case of the third taxable year, this percentage is 50, *i.e.*, 25 divided by 50; in the case of the fourth taxable year, this percentage is 100, *i.e.*, 33⅓ divided by 33⅓; and in the case of the fifth taxable year, this percentage is 100, *i.e.*, 16⅔ divided by 16⅔.

This second amount preserves the full 5-year benefit in cases where the taxpayer's lowest debt is equal to or greater than the product of the 5-year base (unreduced by paydowns) and Act's 5-year percentage. (The Act's 5-year percentage is restructured under the bill as the sum of two applicable percentages: the applicable percentage for the purpose of the general (3-year) rule and the add-on applicable percentage for the purpose of the 5-year rule.) If paydowns have reduced outstanding debt below the amounts that would have obtained full benefit under the 5-year rule had no paydowns occurred, this second amount reduces the 5-year benefit on a linear basis.

The 4-year phase-in amount is the lesser of two amounts. These amounts parallel the principles set forth above in connection with the 5-year amounts. The first amount is the applicable percentage of the "4-year base." The 4-year base is the excess (if any) of the amount taxpayer's outstanding indebtedness on December 31, 1983, over the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1982. For this purpose, however, the 4-year base cannot exceed the excess of the aggregate amount of indebtedness of the taxpayer outstanding on November 16, 1985 over the 5-year base. The applicable percentage, in each year, is the excess of the percentage granted relief under the Act's 4-year phase-in over the percentage granted relief under the Act's 4-year phase-in over the percentage granted relief under the Act's general (3-year) phase-in. In the case of the first taxable year beginning after December 31, 1986, the applicable percentage is 5 (80–75); in the case of the second taxable year, the applicable percentage is 10 (60–50); in the case of the third taxable year, the applicable percentage is 15 (40–25); and in the case of the fourth taxable year, the applicable percentage is 20.

The 4-year phase-in amount cannot exceed a second amount. That second amount is intended to reduce the 4-year phase-in amount to the extent that paydowns reduce the taxpayer's debt below the amount that would be eligible for 4-year relief had no paydown occurred. More specifically, the second amount is the 4-year base, reduced (but not below zero) by certain paydowns of debt, multiplied by a percentage. The paydowns that reduce the 4-year base for this purpose are generally defined as the excess of the taxpayer's November 16, 1985, debt, over the lowest amount of indebtedness of the taxpayer outstanding as of the close of any preceding month beginning after November 16, 1985 (or to the extent provided in regulations, as under the general phase-in, the average amount of indebtedness outstanding during any such month). This paydown amount for 4-year purposes is reduced, but not below zero, by the amount of the 5-year base.

For purposes of this second amount, the (possibly reduced) 4-year base is multiplied by a fraction the numerator of which is the percentage added to general relief under the 4-year rule and the denominator of which is the percentage granted relief after the application of both the 4-year rule and the general (3-year) relief. In the case of the first taxable year beginning after December 31, 1986, this percentage is 6.25, *i.e.,* 5 divided by (5+75); in the case of the second taxable year, this percentage is 16⅔, *i.e.,* 10 divided by 60; in the case of the third taxable year, this percentage is 37.50, *i.e.,* 15 divided by 40; and in the case of the fourth taxable year, this percentage is 100, *i.e.,* 20 divided by 20.

The bill provides that, to the extent possible, the general and special phase-in rules are to apply to the same amount of indebtedness.

The bill clarifies that amounts eligible for relief under the Act's phase-in rules are determined on the basis of indebtedness rather than interest expense. The bill is not intended to require that specific interest expense be traced to specific indebtedness.

The following examples involve the application of the special phase-in rule for one-taxpayer treatment and the general phase-in rule for the Act's other interest expense allocation rules.

Example 1

A U.S. parent company, a calendar year taxpayer, had outstanding third party interest-bearing debt of $50 from 1980 until December 31, 1982. On July 1, 1983, the taxpayer's third party interest-bearing debt increased to $70. On July 1, 1984, the taxpayer's third party interest-bearing debt increased to $100. All this debt bore and bears annual interest at the same interest rate.

The U.S. parent corporation's third party debt is $100 on November 16, 1985, and at all relevant times thereafter.

The general transition rule prevents application of any of the Act's interest expense allocation rules (other than the one-taxpayer rule of Code sec. 864(e)(1)) to interest on 75 percent of $100, the November 16, 1985 amount. That is, the new rules (other than the one-taxpayer rule of Code sec. 864(e)(1), discussed below) cannot apply to interest of $75 of debt. The bill's limitation on the general phase-in amount does not affect this result because the taxpayer's debt level has not dipped below the amount otherwise eligible for general phase-in treatment, i.e., $75.

The special phase-in rule, which governs the application of the one-taxpayer rule of Code sec. 864(e)(1), operates as follows. The special phase-in amount, that is, the amount eligible for special phase-in treatment is the sum of the general phase-in amount (determined above to be $75) and the 5- and 4-year amounts.

The 5-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage of the "5-year base." The 5-year base is $30, the excess of $100, the amount of the taxpayer's outstanding indebtedness on May 29, 1985, over $70, the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1983. The applicable percentage, in the first taxable year beginning after December 31, 1986, is 8⅓. Thus, the first amount is $2.50, that is, 8⅓ percent of $30.

The 5-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 5-year base, $30, unaffected here by paydowns of debt since none have occurred, and then multiplied by 10 percent, *i.e.*, 8⅓ divided by the sum of 8⅓ and 75. Thus, the second amount is $3 ($30 multiplied by 10 percent).

In this case, the 5-year amount is thus $2.50, the lesser of $2.50 and $3.

The 4-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage of the "4-year base." The 4-year base is $20, the excess of $70, the amount of the taxpayer's outstanding indebtedness on December 31, 1983, over $50, the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1982. The applicable percentage, in the first taxable year beginning after December 31, 1986, is 5. Thus, the first amount is $1, that is, 5 percent of $20.

The 4-year phase-in amount cannont exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 4-year base, $20, unaffected here by paydowns of debt since none have occurred, and then multiplied by 6.25 percent, *i.e.*, 5 divided by the sum of 5 and 75. Thus, the second amount is $1.25 ($20 multiplied by 6.25 percent).

In this case, the 4-year amount is thus $1, the lesser of $1 and $1.25.

Thus, in this example, the amount of debt qualifying for relief from one-taxpayer treatment is $78.50, which is the sum of $75, the general phase-in amount; $2.50, the 5-year phase-in amount; and $1, the 4-year phase-in amount. In this example, then, since the indebtedness to which the general phase-in applies is to be, to the extent possible, the same indebtedness to which the special phase-in applies, interest expense on $75 of debt is to be allocated under old law, interest expense on $3.50 of debt is to be allocated without use of the one-taxpayer rule but with use of the Act's other rules governing interest allocation, and interest on $21.50 is to be apportioned under the Act's new rules.

Example 2

Assume the same facts as in the example above, except that the U.S. parent corporation's third party debt is $100 on November 16, 1985, and until January 1, 1987, at which time it pays its debt down to $85. Its debt remains $85 at all relevant times thereafter.

Again, the general transition rule prevents application of any of the Act's interest expense allocation rules (other than the one-taxpayer rule of Code sec. 864(e)(1)) to interest on $75. That is, the new rules (other than the one-taxpayer rule of Code sec. 864(e)(1), discussed below) cannot apply to interest on $75 of debt. The bill's limitation on the general phase-in amount does not affect this result because the taxpayer's lowest debt level, $85, has not dipped below the amount otherwise eligible for general phase-in treatment, i.e., $75.

The special phase-in rule, which governs the application of the one-taxpayer rule of Code sec. 864(e)(1), operates as follows. The amount eligible for special phase-in treatment is the sum of the general phase-in amount (again determined above to be $75) and the 5- and 4-year amounts.

The 5-year phase-in amount is the lesser of two amounts. The first amount is again $2.50, that is, 8⅓ percent of $30.

The 5-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, the second amount is the 5-year base, $30 reduced by the $15 paydown of debt (representing the difference between the November 16, 1985, amount and the $85 lowest monthly amount) to $15 and then multiplied by 10 percent. Thus, the second amount is $1.50 ($15 multiplied by 10 percent).

In this case, the 5-year amount is thus $1.50, the lesser of $2.50 and $1.50.

The 4-year phase-in amount is again the lesser of two amounts. The first amount again is $1, that is, 5 percent of $20.

The 4-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 4-year base, $20, subject to reduction on account of the paydown of debt, multiplied by 6.25 percent. There is no reduction on account of paydowns in this example, because the $15 paydown for 4-year purposes is reduced, but not below zero, by the $30 amount of the 5-year base. Thus, the second amount is again $1.25 ($20 multiplied by 6.25 percent).

In this case, the 4-year amount is thus $1, the lesser of $1 and $1.25.

Thus, in this example, the amount of debt qualifying for relief from one-taxpayer treatment is $77.50, which is the sum of $75, the general phase-in amount; $1.50, the 5-year phase-in amount; and $1, the 4-year phase-in amount. In this example, then since the indebtedness to which the general phase-in applies is to be, to the extent possible, the same indebtedness to which the special phase-in applies, interest expense of $75 of debt is to be allocated under old law, interest expense on $2.50 of debt is to be allocated without use of the one-taxpayer rule but with use of the Act's other rules governing interest allocation, and interest on $22.50 is to be apportioned under the Act's new rules.

Example 3

A third example examines the third taxable year beginning after 1986, the calendar year 1989. In this example, the facts are the same as in the first two examples, except that the taxpayer paid its debt down to $80 on January 1, 1989. Its debt remains at $80 throughout 1989.

The general transition rule prevents application of any of the Act's interest expense allocation rules (other than the one-taxpayer rule of Code sec. 864(e)(1) to 25 percent of $100, the November 16, 1985 amount. That is, the new rules (other than the one-taxpayer rule of Code sec. 864(e)(1), discussed below) cannot apply to interest of $25 of debt. The bill's limitation on the general phase-in amount does not affect this result because the taxpayer's debt level has not dipped below $25.

The special phase-in rule, which governs the application of the one-taxpayer rule of Code sec. 864(e)(1), operates as follows. The amount eligible for special phase-in treatment is the sum of the general phase-in amount (determined above to be $25) and the 5- and 4-year amounts.

The 5-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage (25) of the 5-year base ($30). Thus, the first amount is $7.50, that is, 25 percent of $30.

The 5-year phase-in amount cannot exceed a second amount. In the case of the third taxable year beginning after December 31, 1986, that second amount is $5 (the 5-year base, $30, reduced by the $20 paydown) multiplied by 50 percent. Thus, the second amount is $5 ($10 multiplied by 50 percent).

In this case, the 5-year amount is thus $5, the lesser of $7.50 and $5.

The 4-year phase-in amount is the lesser to two amounts. The first amount is the applicable precentage for the third taxable year beginning after 1986 of the 4-year base ($20). The applicable percentage, in the third taxable year beginning after December 31, 1986, is 15. Thus, the first amount is $3, that is, 15 percent of $20.

The 4-year phase-in amount cannot exceed a second amount. In the case of the third taxable year beginning after December 31, 1986, that second amount is the 4-year base, $20, subject to reduction of account of the paydown of debt, multiplied by 37.5 pervent. There is no reduction on account of paydowns in this example, because the $20 paydown for 4-year purposes of reduced, but not below zero, by the $30 amount of the 5-year base. Thus, the second amount is $7.50 ($20 multiplied by 37.5 percent).

In this case, the 4-year amount is thus $3, the lesser of $3 and $7.50.

Thus, in this example, the amount of debt qualifying for relief from one-taxpayer treatment is $33, which is the sum of $25, the general phase-in amount; $5, the 5-year phase-in amount; and $3, the 4-year phase-in amount. In this example, then, since the indebtedness to which the general phase-in applies is to be, to the extent possible, the same indebtedness to which the special phase-in applies, interest expense on $25 of debt is to be allocated under old law, interest expense on $8 of debt is to be allocated without use of the one-taxpayer rule but with use of the Act's other rules governing interest allocation, and interest on $67 is to be apportioned under the Act's new rules.

Example 4

A U.S. parent company, a calendar year taxpayer, had no outstanding third party interest-bearing debt until July 1, 1984, on which date the taxpayer's third party interest-bearing debt became $100. All this debt bore and bears annual interest at the same interest rate.

The U.S. parent corporation's third party debt is $100 on November 16, 1985, and at all relevant times thereafter until January 1, 1986, when it drops to $80. On January 1, 1987, the U.S. parent corporation's third party debt increases to $85.

The general transition rule prevents application of any of the act's interest expense allocation rules (other than the one-taxpayer rule of Code sec. 864(e)(1) to interest on 75 percent of $100, the November 16, 1985 amount. That is, the new rules (other than the one-taxppayer rule of Code sec. 864(e)(1), discussed below) cannot apply to interest on $75 of debt. The bill's limitation on the general phase-in amount does not affect this result because the taxpayer's debt level has not dipped below the amount otherwise eligible for general phase-in treatment, i.e., $75.

The special phase-in rule, which governs the application of the one-taxpayer rule of Code sec. 864(e)(1), operates as follows. The amount eligible for special phase-in treatment is the sum of the general phase-in amount (determined above to be $75) and the 5-year amount, but subject on these facts to a cap. (The 4-year amount is zero.)

The 5-year phase-in amount is the lesser of two amounts. The first amount is the applicable percentage of the "5-year base." The 5-year base is $100, the excess of $100, the amount of the taxpayer's outstanding indebtedness on May 29, 1985, over $0, the amount of the taxpayer's outstanding indebtedness as of the close of December 31, 1983. The applicable percentage, in the first taxable year beginning after December 31, 1986, is 8⅓. Thus, the first amount is $8.33, that is, 8⅓ percent of $100.

The 5-year phase-in amount cannot exceed a second amount. In the case of the first taxable year beginning after December 31, 1986, that second amount is the 5-year base, $100, reduced by the $20 paydown to $80, and then multiplied by 10 percent. Thus, the second amount is $80 multiplied by 10 percent).

In this case, the 5-year amount is thus $8, the lesser of $8.33 and $8.

Before application of the cap to the special phase-in amount, the special phase-in amount is $83, that is, the sum of $75 and $8. The special phase-in amount, however, cannot exceed $80, the lowest amount of debt outstanding as of the close of any preceding month beginning after November 16, 1985. Therefore, the amount of debt qualifying for relief from one-taxpayer treatment is $80. In this example, then, since the indebtedness to which the general phase-in applies is to be, to the extent possible, the same indebtedness to which the special phase-in applies, interest expense on $75 of debt is to be allocated under old law, interest expense on $5 of debt is to be allocated without use of the one-taxpayer rule but with use of the Act's other rules governing interest allocation, and interest on $20 is to be apportioned under the Act's new rules.

The bill clarifies that for transition rule purposes, all members of an affiliated group of corporations are to be treated as one corporation. Thus, the bill makes it clear that debt of all members is to be aggregated in determining if a paydown that reduces phase-in benefits has occurred. Similarly, the bill makes it clear that interest on interaffiliate debt is not eligible for transition relief.

Finally, in view of the relative complexity of these transition rules, the bill allows taxpayers to elect out of their application in prescribed circumstances.

C. U.S. Taxation of Income Earned Through Foreign Corporations (Sec. 6672(i)-(l) of the Bill, Secs. 1023, 1221, and 1224-1226 of the Reform Act, and Secs. 245, 246A, 552, 861, 881, 901, and 951-955 of the Code)

1. Captive insurance companies

Present Law

Election to treat related person insurance income as effectively connected with a U.S. business

Under subpart F of the Code, certain types of income of U.S.-controlled foreign corporations are included currently in shareholder income and taxed by the United States regardless of whether the income is actually distributed currently to shareholders. A taxpayer is generally subject to income inclusion under subpart F only if the taxpayer is a "U.S. shareholder" in a "controlled foreign corporation." Since the enactment of the subpart F rules in 1962, the term "U.S. shareholder" has generally been limited to those U.S. persons owning (directly, indirectly, or by attribution) 10 percent or more of a foreign corporation's combined voting power. The term "controlled foreign corporation" has generally been limited to those foreign corporations more than half of the stock of which is owned by U.S. shareholders (under the Act, more than half by vote or by value).

The Act introduced new subpart F rules for taxing the income of so-called captive foreign insurance companies. Under the new rules, related person insurance income of these companies is currently taxable to an expanded category of U.S. persons. The statute achieves this result first by treating as a "U.S. shareholder" any U.S. person who owns directly or indirectly *any* stock in a foreign corporation, whether or not it meets the 10 percent threshold; and second by lowering the U.S. shareholder ownership threshold for controlled foreign corporation status to 25 percent or more. These modifications apply only for purposes of taking into account related person insurance income under subpart F.

The Act provides three exceptions to the new subpart F rules for captive insurers. Under one of these exceptions, a foreign corporation may avoid the application of the new subpart F rules for captives by electing to treat related person insurance income that would not otherwise be taxed on a net basis (i.e., as effectively connected with the conduct of a U.S. trade or business) as income that *is* effectively connected with the conduct of a U.S. trade or business. The income deemed to be effectively connected under this election will be excluded from subpart F income.

Congress intended the election to be available only to (a) those corporations that are controlled foreign corporations solely by virtue of the new rules for captive insurers and (b) those corporations that are controlled foreign corporations regardless of the new captive rules but that do not have a U.S. shareholder that directly or indirectly (without attribution under section 958(b)) owns stock in the controlled foreign corporation. The Act provides that the election is to be made as such time and in such manner as the Secretary may prescribe. The election is effective in the year made and in all future years. The election is not effective if the electing corporation fails to meet such requirements as the Secretary shall prescribe to ensure that the tax imposed on its related person insurance income is paid.

To make the election, the foreign corporation must waive all U.S. income tax treaty benefits with respect to its related person insurance income. Treaty benefits with respect to the branch profits tax newly created by the Act are irrelevant to income with respect to which the election is properly made, however, because the Act excludes from the imposition of branch profits tax the earnings and profits attributable to income treated as effectively connected solely because of the election.

Amount of subpart F inclusion

When a controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's U.S. shareholders currently on their pro rata share of the subpart F income. Related person insurance income (as defined by the Act) is a type of subpart F income.

In the case of a corporation that is a controlled foreign corporation for its entire taxable year, and a U.S. shareholder that owns the same proportion of stock in the corporation throughout the corporation's taxable year, the U.S. shareholder's pro rata share of subpart F income is the amount that would have been distributed with respect to the shareholder's stock if on the last day of the taxable year the controlled foreign corporation had distributed all of its subpart F income pro rata to all of its shareholders.

The pro rata share definition provides for adjustments where the corporation is a controlled foreign corporation for less than the entire year or where actual distributions are made with respect to stock the shareholder owns for less than the entire year. The latter adjustment, contained in section 951(a)(2)(B), reduces a U.S. shareholder's pro rata share by a fraction of the dividends distributed to any other person during the controlled foreign corporation's taxable year on stock owned by the U.S. shareholder at year-end. The fraction equals the proportion of the taxable year during which the U.S. shareholder did not own the stock.

Primary insureds

The Act defines related person insurance income as any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (as defined above) in the foreign corporation receiving the income or a person related to such a shareholder.

It was Congress' intent that related person insurance income include income attributable to policies of reinsurance issued by a foreign corporation to its U.S. shareholders that previously insured the risks covered by such priorities or to persons related to such shareholders that previously insured the risks covered by such policies. In addition, Congress gave the Secretary authority under the Act to prevent the avoidance of the captive insurance rules through cross insurance arrangements or otherwise.

The new subpart F rules for captive insurers do not apply if less than 20 percent of the stock of the corporation (by vote or by value of both stock and policies) is owned (directly or indirectly) by persons who are the primary insureds under any policies of insurance or reinsurance issued by the corporation, or by persons related to such primary insureds.

Gross insurance income

Under a de minimis exception to the new subpart F rules for captive insurers, these rules do not apply to income of a foreign corporation whose related person insurance income for the taxable year is less than 20 percent of its insurance income for the year. Congress intended that this computation be performed on a gross basis. Insurance income is defined for this purpose as it is generally for subpart F purposes under the Act, except that the exclusion of income attributable to same-country risks does not apply.

Definition of related person

The application of the new captive insurance rules turns on the distinction between persons who are and are not related to U.S. shareholders (within the meaning of section 954(d)(3) as amended by the Act). A person is related to a controlled foreign corporation if the person controls, is controlled by, or is under common control with the controlled foreign corporation.

Congress intended that related person insurance income include income attributable to officers' or directors' insurance where the U.S. shareholders of the foreign corporation receiving such income (or persons related to such shareholders) directly or indirectly pay the premiums and the insureds are officers or directors of the U.S. shareholders (or persons related to such shareholders).

Definition of related person insurance income

As stated above, the Act defines related person insurance income as a type of "insurance income." The Code provides special rules for computing tax haven insurance income. Section 953(b) states that for these purposes all items of income, expenses, losses, and deductions shall be properly allocated or apportioned under regulations prescribed by the Secretary. Section 953(b) also eliminates or limits the applicability of certain provisions of subchapter L of the Code ("Insurance Companies") for these purposes. Congress intended that these special rules for computing tax haven insurance income apply in computing related person insurance income.

Information return

Under the Code, U.S. persons who own or acquire 5 percent or more of the value of stock of a foreign corporation, others who become U.S. persons while owning that percentage of the stock of a foreign corporation, and U.S. citizens and residents who are officers or directors of foreign corporations with such U.S. ownership are required to file information returns concerning the corporation and its shareholders (sec. 6046; *see* Schedule O (form 5471) (previously Form 959)). Regulations excuse any shareholder from furnishing required information if it is furnished by another person having an equal or greater stock interest in the corporation (Reg. sec. 1.6046-1(e)(5)). Due to its 5 percent stock ownership threshold, this reporting requirement generally applied to all U.S. shareholders in controlled foreign corporations prior to the Act. Under the new captive rules, however, a person owning less than 5 percent of the stock of a controlled foreign corporation may also be a U.S. shareholder. Generally Congress did not intend to treat such less-than-5-percent U.S. shareholders any differently from other U.S. shareholders in controlled foreign corporations for reporting purposes.

Sales of captive company stock

Generally, a U.S. shareholder in a controlled foreign corporation receives an income inclusion under subpart F when the shareholder owns stock in the corporation on the last day of the taxable year on which the corporation is a controlled foreign corporation (sec. 951(a)(1)). Prior to the Act, any U.S. shareholder that sold or exchanged stock in a controlled foreign corporation (or received a distribution which was treated as an exchange of stock in the corporation) before the last day of the year generally would have been required to treat the gain on the sale as a dividend, to the extent of the earnings and profits of the corporation attributable to such stock and accumulated since 1962 during periods in which the corporation was a controlled foreign corporation and in which the U.S. person held the stock sold or exchanged (sec. 1248). Thus a midyear stock sale would result in shareholder dividend income similar to an income inclusion under subpart F.

Under present and prior law, this rule for treating gains as dividends applies only to the class of U.S. shareholders defined under the usual 10 percent ownership threshold of subpart F—that is, the class of U.S. shareholders as that term was defined prior to the Act. The Act's captive insurance rules, however, created a new class of U.S. shareholders that need not satisfy this 10 percent threshold. Congress did not intend to treat this new class of U.S. shareholders differently from 10-percent U.S. shareholders for purpose of the existing rule for treating gains as dividends.

Uninsured, unrelated shareholders

Under the new captive insurance rules, the term U.S. shareholder includes a U.S. person that owns any stock in a foreign corporation that owns (directly or indirectly) any stock in a foreign corporation that earns related person insurance income.

Explanation of Provisions

Election to treat related person insurance income as effectively connected with a U.S. business

The bill supplements the Code provisions describing the election to treat related person insurance income as effectively connected with the conduct of a U.S. trade or business in order to clarify that the election is not available to a corporation that, without applying the special subpart F rules for captive insurance companies, is a controlled foreign corporation with a U.S. shareholder that owns directly or indirectly (without application of the attribution rules of 958(b)) stock in the foreign corporation for any pre-election taxable year beginning after 1986. The bill further provides that if a corporation is entitled to make the election in one year, but in a later year becomes a controlled foreign corporation with such a U.S. shareholder as defined by the general subpart F rules, an election made for the earlier year shall not apply to any taxable year after the later year. Thus, the bill clarifies that the election is available only in situations where a foreign corporation and its shareholders are subject to subpart F treatment by virtue of the Act's special captive insurance rules, and not where subpart F treatment results from application of the rules that are generally applicable outside the captive insurance context.

The bill also provides that in making the election the foreign corporation must waive all benefits granted by the United States (other than benefits with respect to the branch profits and branch interest taxes newly imposed by the Act) under any treaties between the United States and any foreign country. Thus, for example, U.S. tax benefits claimed under a friendship, commerce, and navigation treaty would have to be waived by a foreign corporation making the election. However, the bill clarifies that treaty benefits with respect to the branch taxes need not be waived with respect to related person insurance income when that income is effectively connected without regard to the election.

Amount of subpart F inclusion

The bill provides a special definition of "pro rata share" for purposes only of taking into account related person insurance income. For these purposes, the special pro rata share definition is the lesser of (i) the amount which would be determined under the general subpart F definition of pro rata share if only related person insurance income were taken into account, if stock owned by U.S. shareholders on the last day of the taxable year were the only stock in the foreign corporation, and if only distributions received by U.S. shareholders were taken into account under section 951(a)(2)(B); or (ii) the amount which would be determined under the general subpart F definition of pro rata share if the entire earnings and profits of the corporation for the taxable year were subpart F income.

For example, assume that throughout the first taxable year of a foreign corporation, 50 percent of its stock is owned by U.S. persons and the rest by foreign persons unrelated to U.S. persons. The corporation's only activity is insuring risks of its U.S. shareholders and its foreign shareholders. During the taxable year exactly 50 percent of its income is related person insurance income and its earnings and profits for the year are twice its related person insurance income for the year. Assume that the corporation has no U.S. tax liability, that it has no other subpart F income for the taxable year, and that it does not distribute any of its earnings or invest in U.S. property during the year.

Under the Act's new rules for captives, all U.S. persons that own stock in the corporation are U.S. shareholders. Under the general subpart F rules for computing their income inclusions, they would be treated as if the corporation distributed to them half of its related person insurance income. This portion of the corporation's related person insurance income would be taxed to the U.S. shareholders; the rest of the corporation's related person insurance income would not be taxed currently by the United States. Under the bill, by contrast, the U.S. shareholders are taxed currently on all of the corporation's related person insurance income.

The effect of the bill's pro rata share definition is to ensure that if related person insurance income of a controlled foreign corporation is at all currently taxable to U.S. shareholders under subpart F, then the full amount of the controlled foreign corporation's related person insurance income will be currently taxable, up to the U.S. shareholder's proportionate share of the controlled foreign corporation's earnings and profits. Where the corporation earns a sufficient level of income that is not related person insurance income, partial ownership of the corporation by foreign persons will not reduce the portion of the corporation's related person insurance income that is currently taxable in the United States. As used in the bill's pro rata share definition, the term "U.S. shareholder" has the meaning that it has when taking into account related person insurance income: i.e., as modified by section 953(c)(1)(a) (which dispenses with the 10 percent threshold).

The bill further provides the Secretary with authority to modify the other rules of subpart F where necessary to permit an appropriate computation of pro rata share under the bill's special rule. For example, it may be necessary or appropriate for the Secretary to coordinate this rule with the general pro rata share definition where the controlled foreign corporation has other types of subpart F income; or regulations may be appropriate for determining how the various types of subpart F income are to be reduced to account for the earnings and profits limitation on subpart F income.

Primary insureds

The bill eliminates the word "primary" from the references to "primary insureds" in the definition of related person insurance income and in the exception from the special captive insurance rules for corporations less than 20 percent of whose owners are insureds or related to insureds. Thus the bill clarifies that these references are intended to cover policies of reinsurance issued to U.S. shareholders and related persons, regardless of whether the contracts being reinsured were issued to unrelated persons. The bill also clarifies that insurance income from contracts insuring indirectly (as well as directly) shareholders or persons related to shareholders of the foreign corporation is included in the definition of related person insurance income and that such persons indirectly (as well as directly) insured are included in the group of insured shareholders and shareholders related to insureds for purposes of determining whether the foreign corporation is less than 20 percent owned by insureds or persons related to insureds.

For example, if a foreign corporation reinsures the risk of a U.S. insurance company that insures a U.S. individual and stock of the foreign corporation is owned by the U.S. individual, then the foreign corporation's income on the reinsurance of the U.S. individual is related person insurance income under the bill because one of its U.S. shareholders is indirectly an insured of the foreign corporation. In addition, if a foreign corporation reinsures the risk of a U.S. insurance company that insures a U.S. individual and stock of the foreign corporation is owned by the U.S. insurance company, then the foreign corporation's income on the reinsurance contract is related person insurance income under the bill because one of its U.S. shareholders is directly an insured of the foreign corporation.

The foregoing amendments affecting the types of insureds whose insurance and reinsurance policies give rise to related person insurance income subject to the new captive rules generally apply to taxable years of foreign corporations beginning after 1987. However, to the extent those amendments simply eliminate the word "primary" from the references to "primary insureds," the amendments are effective as if included in the 1986 Act. That is, effective in taxable years of foreign corporations beginning after December 31, 1986, the word "primary" is dropped from Code sections 953(c)(2) and 953(c)(3)(A). The Secretary retains regulatory authority to identify instances where a stockholder of a foreign corporation (or a related person) is the indirect insured under a policy of insurance or reinsurance issued by the corporation, and to extend related person insurance income treatment to income from reinsurance issued to unrelated parties, in those cases where doing so is necessary to prevent the avoidance of the captive insurer rules.

Gross insurance income

The bill clarifies that for purposes of applying the de minimis exception to the captive insurance rules, comparison of a foreign corporation's related person insurance income to its insurance income is made on a gross basis. Thus, the de minimis rule is applied without regard to the relative profitability of the foreign corporation's related person insurance income, on the one hand, and its total insurance income, on the other.

Definition of related person

The bill modifies the definition of related person for purposes of the captive insurance rules, making it clear that in the case of any insurance policy covering liability arising from services performed as a director, officer, or employee of a corporation or as a partner or employee of a partnership, the person performing the services and the entity for which the services are performed will be treated as related persons. (As discussed below, the bill also raises the control threshold for related person status generally from 50 percent to more than 50 percent.)

Definition of related person insurance income

The bill refines the definition of related person insurance income so that it specifically refers to insurance income as that term is defined in section 953(a), thus incorporating the special rules set forth in 953(b) for computing tax haven insurance income.

Information returns

The bill extends the information reporting requirements for U.S. persons who are 5 percent-or-more shareholders of foreign corporations and U.S. citizens or residents who are officers or directors of such corporations so that they apply to all persons who are U.S. shareholders in controlled foreign corporations by virtue of the new captive insurance company rules and all U.S. officers and directors of companies that are controlled foreign corporations by virtue of those rules.

Sales of captive company stock

The bill modifies the treatment of gains on sales of stock in foreign corporations that are controlled foreign corporations under the captive insurance rules to conform to the dividend treatment accorded to gains on sales of controlled foreign corporation stock in general. Thus, when a person that is a U.S. shareholder solely by virtue of the captive rules sells captive company stock to another U.S. person, for example, before the end of the taxable year, buyer and seller will each be treated as having received dividend income only with respect to that part of the year that it owned the stock.

Uninsured, unrelated shareholders

The bill gives the Secretary authority to provide regulations under which U.S. persons who are neither insured or reinsured by a foreign corporation (directly or indirectly), nor related to a person insured or reinsured (directly or indirectly) by the corporation will not be treated as U.S. shareholders of the foreign corporation.

The committee anticipates that the Secretary will exercise this authority to provide for instances where it is administratively impracticable to identify noninsureds with insignificant, indirect shareholdings in foreign corporations as U.S. shareholders. Morever, the committee anticipates that the Secretary may excuse such a U.S. person from treatment as a U.S. shareholder of the captive company even if a U.S. person *can* be identified as the indirect owner of stock of a captive insurance company, if the captive stock represents an insignificant enough portion of the assets of its direct owner. For example, where a publicly traded, widely held, foreign corporation incidentally owns stock (directly or indirectly) in a foreign corporation with related person insurance income, U.S. investors who own small proportions of the stock of the first corporation and who have no relationship to the second may technically be U.S. shareholders under the statute. In these circumstances, however, it might be appropriate for regulations to exclude such investors from the definition of U.S. shareholder.

2. Insurance companies in general

Present Law

Fresh start for computing discounted unpaid losses

To take partial account of the time value of money, the Act amends subchapter L of the Code to provide for the discounting of the deduction for loss reserves of property and casualty insurance companies. Thus, the Act limits the deductions for unpaid losses to the amount of discounted unpaid losses (new sec. 846 of the Code).

In general, the new discounting provisions apply to taxable years beginning after December 31, 1986. A fresh start is provided with respect to undiscounted loss reserves applicable to the last taxable year beginning before January 1, 1987. Under this fresh start rule, the difference between the amount of undiscounted loss reserves and the discounted balances is not taken into income.

The Act provides that the fresh start adjustment is to be taken into account in full in the first taxable year to which the discounting provisions apply (generally, taxable years beginning in 1987) for purposes of calculating any adjustment to earnings and profits. The current earnings and profits of a controlled foreign corporation serve as a limitation on the amount of the corporation's subpart F income for the current taxable year.

Definition of United States risk

Section 861(a)(7) (unchanged by the Act) treats as U.S. source income amounts received as underwriting income derived from the insurance of U.S. risks as defined in section 953(a). Prior to the Act, section 953(a) defined the term "income derived from the insurance of U.S. risks" as income that would (subject to certin modifications described in section 953(b)) be taxed under subchapter L if the income were that of a domestic insurance company, and that is attributable to the reinsuring or the issuing of any insurance or annuity contract (1) in connection with property, activities, or the lives or health of individuals resident in the United States, or (2) under any arrangement where another corporation receives a substantially equal amount for covering such risks.

In connection with the Act's expansion of the subpart F tax haven insurance definition, extending current taxation to any income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks in a country other than that in which the insurer is created or organized, the definition of U.S. risk was no longer relevent for section 953(a) purposes. Cognress did not intend to alter the substance of the related source rule in section 861(a)(7).

Allocation of insurance company expenses

In connection with prior law's shareholder-level taxation of controlled foreign corporation income from insurance of U.S. risks, the Code provided for tax on all of the underwriting income and net investment income from insuring such risks. Certain deductions generally allowed domestic insurance companies were not allowed in the case of these foreign operations, and other allowed deductions were to be taken into account only to the extent they were in respect of contracts insuring U.S. risks. All other deductions, as well as all items of income, were to be properly allocated or apportioned under regulations between income from insuring U.S. risks and income from insuring foreign risks. Under this regime, for example, the regulations generally allocated reserve deductions to underwriting income (*see* Reg. sec. 1.953-4(h)).

The Act not only imposed on U.S. shareholders current taxation on all of the controlled foreign risks outside its home country ("non-same-country risks"), but also subjected income derived from the corporation's investments of funds generally to current U.S. taxation under subpart F, regardless of the extent to which the corporation receiving such income is engaged in the business of insuring same-country risks. Congress intended that, under the existing statute calling for regulations to allocate and apportion deductions with respect to insurance income, reserve and other deductions would be allocated and apportioned, where appropriate, to investment income so as to result in current taxation of net investment income and deferral of tax on same-country underwriting income without, in the latter case, reduction for expenses, losses, or reserves properly allocable to investment income.

Carryover of insurance company deficits

Under the Act, subpart F insurance income of a controlled foreign corporation may be reduced by post-1986 accumulated deficits in that corporation's earnings and profits attributable to activities that give rise to subpart F insurance income, provided that the controlled foreign corporation receiving such income was a qualified insurance company. A qualified insurance company is a controlled foreign corporation predominantly engaged in the active conduct of an insurance business in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit. Thus, a qualified insurance company's investment income attributable to non-same country insurance (which is a type of subpart F insurance income) may be eligible for reduction by accumulated deficits.

A qualified insurance company's investment income attributable to *same* country insurance is generally foreign personal holding company income. Foreign personal holding company income may sometmes be reduced by accumulated deficits under a rule similar to that for subpart F insurance income, but generally not if the income is earned by an insurance company eligible for the benefits of the insurance income deficit rule. Rather, the opportunity to reduce foreign personal holding company income by accumulated deficits is available only if the controlled foreign corporation receiving such income was predominantly engaged in the active conduct of a banking, financing, or similar business in both the year in which the corporation earned the income and the year in which the corporation incurred the deficit.

Explanation of Provisions

Fresh start for computing discounted unpaid losses

The bill provides that for purposes of computing the earnings and profits limitation on subpart F income, current earnings and profits are determined without regard to the increase in current earnings and profits under the discounting fresh start provision of the Act. Thus, the one-time increase in current earnings and profits of a controlled foreign corporation under the discounting fresh start provision will not result in any increase in subpart F income of that corporation.

Definition of United States risk

The bill reinstates for purposes of 861(a)(7) the pre-Act definition of income from U.S. risks. The bill treats as U.S. source income amounts received as underwriting income derived from the issuing (or reinsuring) of any insurance or annuity contract (1) in connection with property, activities, or the lives or health of individuals resident in the United States, or (2) under any arrangement where another corporation receives a substantially equal amount for covering such risks.

Allocation of insurance company expenses

The bill clarifies that regulations are to provide for the proper allocation and appportionment of all insurance company expenses, losses, and deductions between income that is subject to current U.S. shareholder taxation under subpart F (such as investment income) and income that is not (namely, same-country underwriting income). Generally, it is anticipate that amounts not specifically allocable are to be apportioned on the basis of permiums and investment income.

Carryover of insurance company deficits

The bill conforms the treatment of foreign personal holding company income of qualified insurance companies, for accumulated deficit purposes, to that of subpart F insurance income of such companies. Thus, same country and non-same country investment income of a controlled foreign corporation predominantly engaged in the insurance businesss are both eligible for reduction by post-1986 accumulated deficits under the same terms. However, deficits from same country underwriting income continue to be eligible to reduce same country and non-same country investment income earned in later years, for subpart F purposes.

3. Withdrawals of qualified shipping reinvestments that pre-Act law excluded from subpart F income

Present Law

The Act repealed the rule that, under prior law, excluded from subpart F income foreign base company shipping income that was reinvested in foreign base company shipping operations. This change was not intended to modify the taxation of withdrawals (whether by disposition of assets, adjustments to basis, or otherwise) of previously excluded subpart F income from qualified shipping reinvestment for a particular taxable year is measured by reference to the excess of qualified investments as of the close of the last taxable year beginning before 1987 over the qualified investments at the close of the subsequent taxable year.

Explanation of Provision

The bill makes it clear that withdrawals of previously excluded subpart F income from qualified shipping reinvestments are to be taxed only once. For any taxable year beginning after 1986, the amount of withdrawal from qualified shipping investments for that year is limited by the bill to the excess (if any) of (1) the amount of pre-1987 qualified investments determined for prior taxable years beginning after 1986, over (2) qualified shipping investments at year-end. Under this rule, post-1986 investments that meet the definition of qualified investments in foreign base company shipping operations will delay the taxation of withdrawals until all such post-1986 investments are withdrawn.

4. Definition of related person

Present Law

Whether a controlled foreign corporation's income is subject to subpart F will depend in certain cases on whether the income is received from a related person. Generally, for example, dividends, interest, royalties, and rents are subpart F income. However, rents and royalties, for example, may be excluded from subpart F income if derived in the active conduct of a trade or business and received from a person other than a related person (sec. 954(c)(2)(A)). As another example, dividends and interest may be excluded if received from certain related persons organized under the laws of the same country as the controlled foreign corporation (sec. 954(c)(3)(A)(ii)).

A related person is one which controls, is controlled by, or is under common control with the controlled foreign corporation. The Act amended the definition of control for this purpose. In the case of a corporation, control means the direct or indirect ownership of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or of the total value of such corporation. In the case of a partnership, trust, or estate, control is defined as direct or indirect ownership of 50 percent or more of the total value of the beneficial interests in the entity.

Whether income is subject to the separate foreign tax credit limitation for passive income may also turn on whether it is received from a related person. The definition of the passive income basket is generally based on the defintion of foreign personal holding income under subpart F, which in turn uses the concept of "related person" to provide certain exceptions from foreign personal holding company income, such as rents and royalties derived in an active business, and certain same-country dividends and interest. In addition, if a corporation is a controlled foreign corporation, payments that it makes to its U.S. shareholders may be characterized for purposes of the foreign tax credit baskets by reference to the character of the income of the controlled foreign corporation.

In contrast to the definition of control for purposes of defining a related person, the Code treats a foreign corporation as a controlled foreign corporation only if more than 50 percent of its stock (by vote or value) is owned (directly, indirectly, or by attribution) by U.S. shareholders. Prior to the Act, the ownership threshold for related party status was, similarly, *more* than 50 percent of the total combined voting power of a corporation's voting stock.

Different thresholds for defining "control" in the definitions of controlled foreign corporation, on the one hand, and related person, on the other, may produce unintended anomalies in the operation of the foreign tax credit limitation baskets, especially where look-through treatment may be involved. For example, assume that a foreign corporation owned 50–50 by two unrelated persons, one foreign and one U.S., derives all of its income manufacturing, and that it pays royalties to its U.S. shareholder, which derives the royalties in the active conduct of its trade or business. This income of the shareholders is ineligible for the active royalty exception from foreign personal holding company income because the payor is a "related person." However, the foreign corporation is not a controlled foreign corporation, and therefore the royalty income of the shareholder cannot be recharacterized under the look-through rules to reflect the overall limitation character of the foreign corporation's income. Thus, the royalty is passive basket income of the shareholder, even though it would not have been if the U.S. shareholder owned either more or less than 50 percent of the foreign corporation's stock.

Explanation of Provision

The bill provides that control, for purposes of the related person definition of section 954(d)(3), means direct or indirect ownership of more than 150 percent (by vote or value) of the stock of a corporation or more than 50 percent (by value) of the beneficial interests in a partnership, trust or estate. Therefore, as was true prior to the Act, the definitions of both controlled foreign corporation and related person under subpart F are keyed to the same definition of corporation control.

In the case of royalties derived in the active conduct of a trade or business, for example, the bill prevents treatment of a 50-percent U.S.-owned foreign corporation in a manner which is different than the treatment of both foreign corporations owned more than 50 percent by U.S. persons and foreign corporations owned less than 50 percent by U.S. persons. The bill eliminates, by contrast, the opportunity for a controlled foreign corporation to exclude from foreign personal holding company income, under section 954(c)(3)(A)(i), same-country dividends from a 50-percent owned foreign corporation.

5. Treatment of gains as foreign personal holding company income

Present Law

Under the Act, the Code section 954(c) definition of foreign personal holding company income for subpart F purposes includes the excess of gains over losses from sales and exchanges of non-income producing property and property that gives rise to the following types of income: first, dividends and interest; second, rents and royalties other than active business, unrelated party rents and royalties; and third, annuities.

The Act retained certain exceptions to foreign personal holding company treatement from prior law, and added new exceptions to such treatment, in connection with gains of regular dealers; gains on inventory property (sec. 1221(1)); active business gains or losses in connection with certain commodity transactions by any controlled foreign corporation substantially all of the business of which is an active producer, processor, merchant, or handler of commodities; and foreign currency gains and losses related to the business needs of the controlled foreign corporation. For example, the Act retained prior law's subpart F exception for gains and losses of a producer, processor, merchant, or handler of a commodity which arise from bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. Congress did not intend that net losses from the class of transactions the gains on which are covered by the regular dealer and inventory exceptions would be available to reduce foreign personal holding company income.

Explanation of Provisions

The bill provides that the use of losses to reduce gains on sales or exchanges of property subject to foreign personal holding company treatment does not apply to loss from sales or exchanges of inventory property or from any other property by a regular dealer in that property. Thus the bill clarifies that any excess of losses over gains on such sales or exchanges does not reduce subpart F income.

The bill also provides a new hedging exception for regular dealers in property, under which gains and losses arising out of bona fide hedging transactions reasonably necessary to the conduct of the business of being a dealer in such property are excluded from the computation of foreign personal holding company income. Thus, where a regular dealer in bonds, for example, uses forwards, futures, options, or similar instruments in which it is not a regular dealer to hedge its exposure to losses on its bonds, the bill permits netting of gains and losses from both bonds and hedging instruments in arriving at the dealer's non-subpart F income.

6. Losses from foreign base company sales and services income

Present Law

As described above, the Act provided for reductions of a controlled foreign corporation's subpart F income in certain categories by post-1986 accumulated deficits in that corporation's earnings attributable to activities giving rise to those same categories. The categories of income within which such reductions are available under the Act are foreign base company shipping income, foreign base company oil related income, subpart F insurance income and foreign personal holding company income of qualified banking corporations. For the most part, these are categories from which taxpayers were able to avoid U.S. tax on subpart F income inclusions under the pre-Act rules. For example, much of subpart F insurance income and foreign personal holding company income of qualified banking corporations was not subpart F income at all prior to the 1986 Act. Moreover, pre-Act rules on reinvestment of foreign base company shipping income made it possible to avoid income inclusions on the current income from foreign base company shipping operations.

Foreign base company sales income and foreign base company services income cannot be reduced by accumulated deficits. Prior to the 1986 Act, U.S.C shareholders of controlled foreign corporations earning current income in these subpart F categories were likely to be taxed currently on that income.

Explanation of Provision

The bill adds foreign base company sales income and foreign base company services income to the list of income categories reducible by post-1986 accumulated deficits. In addition, unlike the other categories of income eligible for this treatment, the bill makes foreign base company sales income and foreign base company services income reducible by pre-1987 accumulated deficits. Thus, foreign base company sales income of a controlled foreign corporation may be reduced by accumulated deficits, from any prior year, in that corporation's earnings and profits attributable to activities that give rise to foreign base company sales income. Similarly, foreign base company services income of a controlled foreign corporation may be reduced by accumulated deficits, from any prior year, in that corporation's earnings and profits attributable to activities that give rise to foreign base company services income.

As is true for the other categories of income entitled to similar treatment, accumulated deficits may be used only once, but those that cannot be utilized in one year may be carried over indefinitely for possible use in later years. To be eligible for use under the rule, an accumulated deficit must arise in a year beginning after 1986 for which the foreign corporation incurring such deficit is a controlled foreign corporation. Moreover, the deficit can reduce the subpart F inclusion of only those U.S. persons that are U.S. shareholders in the controlled foreign corporation when the deficit was incurred.

7. Measurement of earnings and profits

Present Law

As noted above, the amount of earnings and profits of a controlled foreign corporation for a taxable year serves as a limitation on the amount of its subpart F income for the year. Except as provided in section 312(k)(4), for purposes of subpart F the earnings and profits (or deficit in earnings and profits) of any foreign corporation for any taxable year generally is determined according to rules substantially similar to those applicable to domestic corporations, subject to regulations.

The Tax Reform Act of 1984 introduced several provisions to make a corporation's earnings and profits more closely conform to its economic income where economic income diverged from taxable income. Under the 1984 Act, for example, a corporation using the LIFO method of accounting for inventory adjusts earnings and profits under rules designed to eliminate the impact of LIFO on earnings and profits (current Code sec. 312(n)(4)). A corporation's earnings and profits for a year in which the corporation sells property on the installment basis generally are to be computed as if the corporation did not use the installment method to account for the installment sale (current Code sec. 312(n)(5)).

A corporation that accounts for income and expenses attributable to a long-term contract on the completed contract method of accounting generally recognizes income and expense in the year in which the contract is completed. Under the 1984 Act, a corporation that accounts for income and expense on this method is required to compute earnings and profits as if it were accounting for income and expense attributable to long-term contracts on a percentage of completion basis (sec. 312(n)(6)).

The effect of these provisions is generally to accelerate the inclusion of amounts in earnings and profits, reducing to some extent amounts of earnings and profits that can be treated as current earnings in future taxable years. In the case of a domestic corporation computing taxable dividends, this reduction in subsequent years' current earnings and profits does not generally reduce the tax on amounts distributed in the subsequent year, because the distribution of accumulated earnings is also taxed.

In the case of computing the subpart F limitation, on the other hand, acceleration of earnings under these provisions generally has the effect of raising the subpart F limitation in an earlier year than the year in which those earnings would be included in taxable income of U.S. shareholders.

The Act put new limits on the amounts by which prior year deficits in earnings and profits, or deficits in non-subpart F income, can be used to reduce subpart F inclusions (sec. 952(c)). Those provisions generally do not, however, provide for increasing the earnings and profits limitation by a prior year excess of earnings and profits over subpart F income, even if those earnings and profits relate to subpart F income categories.

Explanation of Provision

Under the bill, the earnings and profits limitation on subpart F income is to be determined without regard to the rules that accelerate the recognition of earnings and profits from inventory assets accounted for under the LIFO method, from installment sales, and from contracts the income from which is accounted for under the completed contract method. By conforming the computation of earnings and profits for this purpose to the computation of taxable income, the bill ensures that subpart F income inclusions more closely match the controlled foreign corporation's taxable subpart F income. The bill thus reduces the possibility that tax haven income will go untaxed.

The modification also provides, however, that under regulations, if the earnings and profits arising from the inventory assets, installment sale, or completed contract are distributed prior to the year that they would otherwise be included in income (e.g., the year in which the installment receivable is collected or the contract is completed), those earnings are not to be included in income in the later year. This treatment may be necessary to eliminate the potential for those earnings to be taxed twice.

8. Effective date of accumulated earnings tax amendments

Present Law

The Act amended sections 535 and 545 to provide that the accumulated earnings tax and personal holding company tax applicable to a foreign corporation will be calculated by taking net capital gains into account when computing the net capital gain deduction only if they are effectively connected with the conduct of a U.S. trade or business, and only if they are not exempt by treaty from U.S. tax. Congress intended that the amendments apply to gains and losses realized on or after January 1, 1986, rather than only those gains and losses realized after March 1, 1986 as stated in the Act.[1]

Explanation of Provision

The bill amends the effective date of the Act's amendments to section 535 and 545. Under the bill the Act's amendments apply to gains and losses realized on or after January 1, 1986.

9. Dividends received deduction

Present Law

The Act rewrote section 245(a), which governs the deduction for dividends received from foreign corporations, modifying it in several important respects. Under the Act, dividends eligible for the deduction are based on the ratio of (a) the foreign corporation's post-1986 earnings and profits that have been subject to net-basis U.S. corporate income tax and that have not been distributed to (b) the corporation's total accumulated earnings and profits.

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[1] *See* H. Rep. 99-841, Vol. II (September 18, 1986), p. 628 (Conference Report).

The Act disallowed indirect foreign tax credits (sec. 902) to the extent the taxes are attributable to the portion of dividends from foreign corporations that is eligible for the dividends received deduction. In addition, for foreign tax credit limitation purposes, the portion of any dividend from a foreign corporation that is eligible for the dividends received deduction is treated as U.S. source.

Under Code section 1248, where a U.S. person sells or exchanges stock in a foreign corporation (or receives a distribution which is treated as an exchange of stock in a foreign corporation) which was, during the previous 5 years, a controlled foreign corporation in which the U.S. person was a U.S. shareholder, the gain recognized on the sale or exchange is treated as dividend income of the U.S. person to the extent of the earnings and profits of the foreign corporation attributable to such stock and accumulated since 1962 during periods in which the corporation was a controlled foreign corporation and in which the U.S. person held the stock sold or exchanged. For these purposes, certain income items, including generally amounts effectively connected with a U.S. trade or business of the controlled foreign corporation and not exempt from tax (or subject to a reduced tax rate) by treaty, are excluded from earnings and profits. Thus, amounts treated as dividends under section 1248 are generally derived from earnings not subject to U.S. corporate income tax, and therefore generally are not eligible for the dividends received deduction under the Act.

Explanation of Provision

The bill modifies the Act's disallowance of foreign tax credits. The bill extends the potential disallowance to any foreign taxes, those eligible for the direct credit (sec. 901) as well as the indirect credit (sec. 902).

In addition, to the extent that a treaty obligation of the United States requires the United States to treat dividends from a foreign corporation that are eligible for the dividends received deduction as foreign source, the bill allows any recipient of such dividends to elect the treaty source rule, but the bill subjects the portion of dividends from that corporation that would be treated as U.S. source income absent a treaty to their own separate foreign tax credit limitation.

An example illustrates the operation of this provision. A foreign corporation, wholly owned by a U.S. corporation, accumulates $100 of earnings and profits in 1987, of which $60 is post-1986 undistributed U.S. earnings. Because of a U.S. corporate-level tax preference, there is no U.S. corporate tax on the $60 of post-1986 undistributed U.S. earnings. An income tax treaty prevents imposition of the U.S. branch profits tax on this $60 of post-1986 undistributed U.S. earnings. The foreign country imposes $30 of corporate-level tax on this foreign corporation. Of this $30, $18 is attributable to the $60 of post-1986 undistributed U.S. earnings. The foreign corporation distributes $70 to its U.S. corporate shareholder. That $70 incurs a $7 foreign withholding tax, of which $4.20 is attributable to the $60 of pre-foreign corporate-level tax post-1986 undistributed U.S. earnings.

The tax treaty with the foreign corporation's residence country obligates the United States to treat dividends from the foreign corporation as foreign source. The taxpayer elects the treaty source rule. Of the total foreign tax of $37, 60 percent, or $22.20, is attributable to the $60 of post-1986 undistributed U.S. earnings. The U.S. pre-credit tax on the $60 income inclusion, at a 34-percent rate, is $20.40. The $22.20 foreign taxes eligible for credit exceed the $20.40 U.S. tax on the $60 of post-1986 undistributed U.S. earnings. The $1.80 excess may be carried forward for use against the U.S. tax on future dividends out of post-1986 undistributed U.S. earnings from this foreign corporation, but not for other use. (No carryback is possible on these facts, but carrybacks could occur in other cases).

The $40 of dividend income that is not attributable to post-1986 undistributed U.S. earnings is not affected by the bill. That $40 is treated as foreign source income under Code rules, and the $14.80 of foreign tax that is attributable to the $40 is associated with that income (and excess credits are eligible for cross-crediting against income of the taxpayer other than post-1986 undistributed U.S. easrnings) under Code rules.

The bill also provides that for purposes of section 245(a), the term dividend does not include any amount treated as a dividend under section 1248. Thus, the bill clarifies that a taxpayer which is treated as having received dividend income due to the sale or exchange of stock in a controlled foreign corporation will not be eligible for a deduction of any portion of the amount treated as a dividend.

D. Special Tax Provisions for U.S. Persons

1. Possession tax credit (sec. 6674(n) of the bill, sec. 1231 of the Reform Act, and sec. 936 of the Code)

Present Law

Under present law, the possession tax credit is not allowed unless a possessions corporation satisfies a trade or business income test. This test is satisfied if 75 percent or more of the gross income of the possessions corporation in the 3-year period including the current and preceding two taxable years is derived from the active conduct of a trade of business within a possession of the United States. (For taxable years beginning after 1984 and before 1987, a 65-percent trade or business income test was imposed.)

Explanation of Provision

A possessions corporation would not be disqualified in taxable years beginning in 1987 or 1988 if: (1) it meets the 65-percent trade or business income requirement or prior law; (2) 75 percent or more of the gross income of the corporation for taxable years beginning after 1986 is trade or business income; and (3) it elects to reduce qualified possession source investment income to the extent in excess of that allowed under the 1986 Act. Income attributable to disallowed investment income would not be treated as qualified possession source investment income for any taxable year.

2. Effective date of provision governing transfers of intangibles to related parties (sec. 6672(n) of the bill, sec. 1231 of the Reform Act, and sec. 482 of the Code)

Present Law

The Act requires that payments with respect to intangibles that a U.S. person transfers to a related foreign corporation or possessions corporation be commensurate with the income attributable to the intangible. The new provisions carrying out this rule apply to taxable years beginning after December 31, 1986, but only with respect to transfers after November 16, 1985, or licenses granted after that date (or before that date with respect to property not in existence or owned by the taxpayer on that date). For purposes of section 936, the new provisions apply to taxable years beginning after December 31, 1986, without regard to when any transfer (or license) was made.

In view of the fact that the objective of these provisions—that the division of income between related parties reasonably reflect the relative economic activity undertaken by each—applies equally to inbound transfers, Congress concluded that it would be appropriate for these principles to apply to transfers between related parties generally (via Code sec. 482) if income must otherwise be taken into account. However, in the case of a transfer of the type that is covered by the Act but that would not have been affected by the House version of H.R. 3838, Congress intended to apply the above effective date provision substituting "August 16, 1986" for "November 16, 1985."

Explanation of Provision

In the case of transfers and licenses of intangibles which are not to foreign persons (and not to possessions corporations), and therefore not of the type affected by the House version of H.R. 3838, the bill modifies the relevant effective date provision of the Act. In the case of a transfer or license which is not to a foreign person or a possessions corporation, the bill provides that the Act applies to taxable years beginning after December 31, 1986, but only with respect to transfers after August 16, 1986, or licenses granted after that date (or before that date with respect to property not in existence or owned by the taxpayer on that date). The bill clarifies that for purposes of section 936, which governs income from certain intangibles whether or not the intangibles are actually transferred, the Act's provisions apply to taxable years beginning after December 31, 1986, regardless of whether a transfer (or license) was made.

3. Information returns on resident status (sec. 6674(o) of the bill, sec. 1234 of the Reform Act, and sec. 6039E of the Code)

Present Law

The Act provided that an IRS information return generally must be filed in conjunction with a citizen's passport application and with a resident alien's green card application. These returns must provide the individual's taxpayer identification number (if any), information with respect to whether a green card applicant has been required to file a tax return for the individual's most recent three taxable years, and such other information as the Secretary may require. The Act further required U.S. agencies which collect (or are required to collect), the new information returns to provide them, and the names (and any other identifying information) of any individuals who refuse to provide them as required, to the Secretary, notwithstanding any other provision of law.

The Immigration Reform and Control Act of 1986 became law after the Tax Reform Act of 1986. This new immigration law established a legalization program (section 245A of the Immigration and Nationality Act; 8 U.S.C. sec. 1255a). Under the program the U.S. Attorney General is to accord eligible applicants who were undocumented aliens the status of aliens lawfully admitted to the United States for permanent residence. Applicants are to provide the Justice Department with information establishing their eligibility for legalization. The new immigration law contains confidentiality rules, violation of which is punishable as a felony, that generally preclude government employees involved in the legalization program from sharing or disseminating outside the confines of the program information furnished pursuant to an application for legalization.

Explanation of Provision

The bill provides that the confidentiality provisions of the legalization program enacted in the Immigration Reform and Control Act of 1986 are not overridden by the previously enacted Tax Reform Act provisions requiring federal agencies to share information on green card applicants with the Secretary of the Treasury.

4. Treatment of certain passive foreign investment companies (sec. 6674(p) of the bill, sec. 1235 of the Reform Act, and secs. 904, 1246, 1248, 1291, 1293, 1294, 1296, and 1297 of the Code)

Present Law

Overview

The Act established rules for passive foreign investment companies (PFICs) and established separate rules for each of two types of PFICs. One set of rules applies to PFICs that are "qualified electing funds," where each U.S. shareholder includes currently in gross income his or her share of a PFIC's total earnings, with an election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), whose U.S. shareholders pay tax on income realized from a PFIC and an interest charge which is attributable to the value of deferral.

Definition of passive foreign investment company

General definition

A passive foreign investment company (PFIC) is any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or any foreign corporation if 50 percent or more of the average value of its assets consists of assets that produce, or are held for the production of, passive income. Passive income for these purposes means generally income that is includible in the passive income separate foreign tax credit limitation (Code sec. 904(d)(2)(A)), without regard to the exceptions contained therein (i.e., without regard to the exceptions to passive income for income included in other separate foreign tax credit limitations, export financing interest, high-taxed income, and foreign oil and gas extraction income). Thus, for example, passive income does not include any dividend received by a corporation from a related corporation organized in the same foreign country as the shareholder if the dividend is excluded from passive income for foreign tax credit purposes. Although the Act incorporates the definition of passive income that is applied for foreign tax credit limitation purposes, it is unclear whether the look-through rules contained therein (i.e., secs. 904 (d)(3) and (d)(5)), are to the extent applicable, to be used in determining whether income is passive for PFIC purposes as well. Passive assets for this purpose are those assets that produce or are held for the production of passive income. It is intended that assets that are property which, in the hands of the foreign corporation, are inventory property (as defined in sec. 1221(1)), or are held by a regular dealer in that property, be treated as nonpassive assets, even where that property generates passive income, such as in the case of a securities broker-dealer that holds debt securities.

Exceptions to PFIC classification

Except as provided in regulations, passive income does not include income derived by a bona fide insurance company that would be subject to taxation under subchapter L if the company were a U.S. corporation. It was intended that regulations provide that entities engaged in the business of providing insurance derive passive income and, thus, may be PFICs in certain cases where the entities maintain financial reserves in excess of the reasonable needs of their insurance business.

In determining whether foreign corporations that own subsidiaries that are primarily engaged in active business operations are PFICs, look-through treatment is provided in certain cases. Under this look-through rule, a foreign corporation that owns at least 25 percent of the stock of another corporation is treated as owning a proporationate part of the other corporation's assets and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the shareholder' income in applying the income test and the stock or debt investment is eliminated from the shareholder's assets in applying the asset test. It is unclear under the Act whether the look-through rule applies when the 25 percent ownership is indirectly held.

General rule—nonqualified funds

General rule

United States shareholders in PFICs that are not "qualified electing funds" pay U.S. tax and an interest charge based on the value of tax deferral at the time the shareholder disposes of stock in the PFIC or on receipt of an "excess" distribition (Code sec.

1291). Under this rule, gain recognized on disposition of stock in a PFIC or on receipt of an "excess" distribution from a PFIC is treated as ordinary income and is treated as earned pro rata over the shareholder's holding period of his or her investment. Distributions from nonqualified funds are not eligible for a deemed paid foreign tax credit under section 902.

Definition of excess distribution

An "excess" distribution is any current year distribution in respect of a share of stock that exceeds 125 percent of the average amount of distributions in respect of the share of stock received during the 3 preceding years (or, if shorter, the total number of years of the taxpayer's holding period prior to the current taxable year). It is unclear whether excess distributions are included in determining any 3-year average distribution amount in respect of a share of stock.

Although the Act provided for certain adjustments in determining the amount of an excess distribution, the Act did not provide any adjustment for amounts that may be currently included in income under other current inclusion rules.

Anti-avoidance rules

The Act, in addition to incorporating certain anti-avoidance rules in present law section 1246 (relating to foreign investment companies), provided the Secretary the authority to disregard any nonrecognition provision of present law on dispositions of PFIC stock. For example, it is contemplated that regulations may treat a gift of stock in a nonqualified fund to a non-taxpaying entity, such as a charity or a foreign person, as a disposition for purposes of those rules in order that the deferred tax and interest charge attributable to that stock not be eliminated.

Qualified electing funds

General rule

United States persons who own stock in a "qualified electing fund" must include currently in gross income their pro rata share of the PFIC's total earnings and profits. This inclusion rule requires current payment of tax, absent a shareholder-level election to defer tax. A qualified electing fund is any PFIC that properly elects with the Secretary and complies with the requirements the Secretary prescribes to determine the income of the PFIC, to ascertain its stock ownership, and to ascertain any other information necessary to carry our the purposes of those rules.

The amount currently included in income is divided between a shareholder's pro rata share of the ordinary income of a PFIC and net capital gain income of a PFIC. The characterization of income, and the determination of earnings and profits, is made pursuant to general Code rules. Pro rata share of income is determined by aggregating a PFIC's income for the taxable year and attributing that income ratably over every day in the PFIC's year. United States persons then included in income for the period in which they hold stock in the PFIC their daily ownership interest in the PFIC multiplied by the amount of income attributed to each day.

Election to defer current payment of tax

United States investors in qualified electing funds may generally, subject to the payment of interest, elect to defer payment of U.S. tax on amounts currently included in income but for which no current distribution has been received. An election to defer tax is treated as an extension of time to pay tax for which a U.S. shareholder is liable for interest.

Certain events cause an extension of time to pay tax on undistributed earnings to terminate. One of those events is the disposition of stock in a PFIC, which terminates all previous extensions of time to pay tax with respect to the earnings attributable to that stock. It is intended that disposition for this purpose mean any transfer of ownership, regardless of whether the transfer constitutes a realization or recognition event under general Code rules. For example, a transfer at death or by gift of stock of a qualified electing fund is to be treated as a disposition for these purposes.

Special rules applicable to both types of funds

Coordination of section 1291 with taxation of shareholders in qualified electing funds

Gain recognized on disposition of stock in a PFIC by a U.S. investor is not taxed under section 1291 if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986 and which include any portion of the investor's holding period.

Distributions received from a PFIC in a year the PFIC is a qualified electing fund are also intended not to be taxed under section 1291 if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986, and which include any portion of an investor's holding period. This provision prevents a fund from retaining its annual income, electing to be a qualified electing fund in a subsequent year, and then distributing the accumulated income without the imposition of an interest charge.

Any U.S. shareholder who owns stock in a PFIC which previously was not a qualified electing fund for a taxable year but which becomes one for the subsequent taxable year may elect to be taxed on the unrealized appreciation inherent in his or her PFIC stock up through the first day of the subsequent taxable year, pay all prior deferred tax and interest, and acquire a new basis and holding period in his or her PFIC investment. Thereafter, the shareholder is subject to the rules applicable to qualified electing funds.

Attribution of ownership

In determining stock ownership, a U.S. person is considered to own his proportionate share of the stock of a PFIC owned by any partnership, trust, or estate of which the person is a partner or beneficiary (or in certain cases, a grantor), or owned by any foreign corporation if the U.S. person owns 50 percent or more of the value of the corporation's stock. However, if a U.S. person owns any stock of a PFIC, the person is considered to own his proportionate share of any PFIC stock owned by the upper-tier PFIC, regardless of the percentage of his ownership in the upper-tier PFIC. In attributing stock ownership, holders of options for stock of a corporation are not treated as owning the stock in the corporation.

Anti-avoidance rules

The Act provided authority to the Secretary to prescribe regulations that are necessary to carry out the purposes of the Act's provisions and to prevent circumvention of the interest charges.

One example where regulations may be necessary to carry out the purposes of the Act's provisions is where the ownership attribution rules impute stock ownership in a PFIC to a U.S. person through an intervening entity and the U.S. person disposes of his interests in the intervening entity. In these cases, the intervening entity may not be a PFIC, so that the U.S. person could technically avoid the imposition of any interest charge. In this instance, regulations are intended to treat the disposition of interests in the intervening entity as a disposition of the PFIC stock. Similarly, if necessary to avoid circumvention of the Act's interest charge, it may be necessary under regulations to treat distributions received by an intervening entity as being received by the U.S. person.

Coordination with other current inclusion and disposition rules

The Act adopted rules to coordinate the PFIC provisions with the subpart F and FPHC current inclusion rules in the case of qualified electing funds. Under these coordination rules, amounts required to be included in income currently under either section 951 or 551 shall be included first under those rules and then any additional amounts shall be included currently under section 1293. The Act did not provide coordination of the PFIC provisions and the subpart F and FPHC provisions for nonqualified funds.

Explanation of Provision

Definition of passive foreign investment company

The bill conforms the PFIC definition of passive income to the definition of passive income under subpart F (sec. 954(c)), subject to an exclusion for dividends and other amounts received with respect to stock in certain related corporations organized in the same country as the shareholder (sec. 954(c)(3)), and subject to a new set of PFIC look-through rules in addition to the Act's rules that treat assets held by, and income received by, certain 25-percent-owned corporations as being held by, and received by, those corporations' shareholders (sec. 1296(c)). These changes make explicit that earnings of certain related foreign corporations that, if paid as a dividend, would be excluded from foreign personal holding company income under subpart F are subject to section 1296(c) look-through treatment (i.e., they are treated as earned directly by the 25-percent of greater parent corporation, and dividends of those earnings are disregarded for purposes of testing the level of the parent's passive income). Moreover, the bill's new PFIC look-through rules are substantially similar to the look-through rules under the foreign tax credit provisions, which were intended to apply for PFIC purposes as well.

Under the bill's new PFIC look-through rules, interest, rents, and royalties received from related persons are treated as passive income to the extent that under regulations those amounts are allocable to income of the payor that is passive income. As a corollary, the characterization of the assets that generate the income will follow the characterization of the income so that, for example, a loan to a related person will be treated as a nonpassive asset if the interest on the loan is treated as nonpassive income. The committee anticipates that the regulations will follow the approach of the foreign tax credit allocation rules in making these allocations for PFIC purposes. The bill defines a related person by reference to the related person definition in subpart F (that is, sec. 954(d)(3)).

The bill clarifies the exception from passive income for income received by bona fide insurance companies. This exception from passive income extends only to income derived by insurance companies that are predominantly engaged in the active conduct of an insurance business and that would be taxed under the speical rules applicable to domestic insurance companies if they were domestic corporations. Thus, income derived by entities engaged in the business of providing insurance will be passive income to the extent the entities maintain financial reserves in excess of the reasonable needs of their insurance business.

The bill clarifies that the look-through rule for 25-percent-owned corporations applies to direct or indirect 25-percent ownership that is held by an upper-tier foreign corporation.

The bill treats stock of certain U.S. corporations owned by another U.S. corporation which is at least 25-percent owned by a foreign corporation as an active asset. Under this rule, in determining whether a foreign corporation is a PFIC, stock of a regular domestic C corporation owned by a 25-percent owned domestic corporation is treated as an asset which does not produce passive income (and is not held for the production of passive income), and income derived from that stock is treated as income which is not passive income. Thus, a foreign corporation, in applying the look-through rule available to 25-percent owned corporations, will be treated as owning non-passive assets in these cases. This rule does not apply, however, if, under a treaty obligation of the United States, the foreign corporation is not subject to the accumulated earnings tax, unless the corporation agrees to waive the benefit under the treaty. This rule is designed to mitigate the potential disparate tax treatment between U.S. individual shareholders who hold U.S. stock investments through a U.S. holding company and those who hold those investments through a foreign holding company. If a foreign investment company attempts to use this rule to avoid the PFIC provisions, it will be subject to the accumulated earnings tax and, thus, the shareholders of that company will be subject to tax treatment equivalent to that of the shareholders of PFICs.

The bill further provides an election to a foreign corporation in determining whether it is a PFIC. Under the election, a foreign corporation can apply the asset test using the adjusted bases of the corporation's assets, rather than the fair market value of its assets, in determining whether it is a PFIC. This rule will simplify the PFIC determination for corporations whose assets' fair market values and adjusted bases are not substantially different. The election, once made, is revocable only with the consent of the Secretary.

Nonqualified funds

The bill makes several modifications and clarifications to the rules applicable to PFICs that are not qualified electing funds.

The bill eliminates the potential for double taxation by coordinating the nonqualified fund rules with the rules applicable to the Code's other current inclusion rules, the subpart F and the foreign personal holding company rules. Thus, for example, excess distributions will not include any amounts that are treated as previously taxed income under section 959(a) when distributed by a controlled foreign corporation that is also a PFIC that is not a qualified electing fund. (Because items of previously taxed income increase a U.S. shareholder's stock basis to the extent those items are not distributed (sec. 961), the deferred tax and interest charge rules of section 1291 that apply to dispositions of stock in a PFIC that is not a qualified electing fund but that is a controlled foreign corporation are not affected by the above-described modifications.)

The bill modifies the determination of an excess distribution to exclude from the 3-year average distribution amount that part of an excess distribution that is considered attributable to deferred earnings (i.e., that part of the excess distribution that is not allocable to pre-PFIC years and to the current year). This modification is necessary to prevent the avoidance of the interest charge that would otherwise be due on accumulated earnings. For example, a PFIC could accumulate earnings for a period of years, and then distribute those earnings ratably over a period greater than three years. If the excess distributions received in the first three years were to be included in the 3-year average distribution amount, distributions received after three years would not be excess distributions, and hence no interest would be imposed on the deferred earnings inherent in those later distributions.

The bill clarifies the detemination of a taxpayer's holding period as it relates to receipt of an excess distribution. This clarification provides that a taxpayer's holding period is considered to end on the date of receipt of an excess distribution but only with respect to that distribution. Thus, the taxpayer's holding period in its stock to which the excess distribution is attributable does not end on the date of receipt of the excess distribution.

The bill repeals the Act's provision which denies U.S. corporate shareholders in PFICs that are not qualified electing funds benefit of the indirect foreign tax credit under section 902. Thus, if a U.S. corporation owns at least 10 percent of the voting stock in a PFIC, the corporation is treated as paying its share of the PFIC's foreign income taxes imposed on the earnings the PFIC distributes to the U.S. corporation.

The bill further clarifies that the regulatory authority provided under the Act to deny the benefits of any nonrecognition treatment extends to any transfers of PFIC stock, including transfers at death or by gift.

Qualified electing funds

The bill also modifies and clarifies the rules applicable to PFICs that are qualified electing funds.

The bill provides that, to the extent provided in regulations, if a qualified electing fund establishes to the Secretary's satisfaction that it maintains records that determine investors' pro rata shares of income more accurately than allocating a taxable year's income ratably over a daily basis (for example, by allocating a month's income ratably over a daily basis), the fund can determine the investors' pro rata shares of income on that basis. This provision is designed to allow those funds that maintain appropriate records to more accurately determine U.S. investors' pro rata shares of income, which may be important in cases where the investors own their stock for only parts of a year. For example, if a PFIC maintains records on a monthly basis and allows redemptions and acquisitions of its stock only at a month's end, this provision would allow U.S. investors to include in income amounts actually earned by the PFIC for each month rather than including in income under the general rule their pro rata share of the year's total income.

The bill modifies the determination of a PFIC's earnings and profits. This modification provides that earnings and profits are computed using the installment method of accounting (and the completed contract method of accounting and the LIFO inventory method, if applicable) if a PFIC uses the method to compute its income. For example, if a PFIC uses the installment method of accounting in computing its income, U.S. investors' pro rata shares of income will take into account that method. This modification only affects earnings and profits for income inclusion purposes. Thus, it does not change earnings and profits for purposes of determining, for example, if a distribution is a dividend. The modification also provides, however, that, under regulations, if the earnings and profits arising from the installment method and considered deferred for income inclusion purposes are distributed prior to the year that they would otherwise be included in income (e.g., the year in which the installment receivable is collected), those earnings are not to be included in income in the later year. This latter rule is necessary to eliminate the potential for double taxation of those earnings.

The bill clarifies that disposition, for purposes of determining whether an extension of time to pay tax on undistributed PFIC earnings terminates, means any transfer of stock, regardless of whether it would give rise to a realization or recognition event under general Code rules. For example, a transfer of stock by gift causes a termination of all prior extensions of time to pay tax for the earnings attributable to that stock.

The bill provides for another event that terminates an extension of time to pay tax on undistributed PFIC earnings. This provision is designed to reflect the Act's policy that tax on an income inclusion should be payable when the shareholder receives the income from the PFIC. Under this provision, if the PFIC lends property, directly or indirectly, to the U.S. shareholder, the loan is treated as a distribution and the extension of time to pay tax on the undistributed PFIC earnings to which the loan is attributable is terminated. In addition, the deemed distribution will reduce the shareholder's PFIC stock basis and the subsequent actual distribution of those earnings will be treated as a distribution that is not a dividend to the extent the shareholder establishes that fact with the Secretary. An indirect loan may occur under this provision where the PFIC lends property to a U.S. corporation in which the U.S. person owns, for example, a 50-percent interest.

The bill provides modifications to the rules applicable to PFICs that are qualified electing funds that are also controlled foreign corporations. First, the amount of income treated as ordinary income on a sale or exchange of stock in a controlled foreign corporation (under sec. 1248) does not include any amount of income previously included under the qualified electing fund rules to the extent that that amount of income has not been distributed from the PFIC prior to the sale or exchange of the stock. Further, look-through treatment is provided in determining the foreign tax credit limitation treatment of income inclusions under the qualified electing fund rules when (1) PFIC is also a controlled foreign corporation, and (2) the U.S. person with the income inclusion is a U.S. shareholder in the controlled foreign corporation. Thus, contrary to the act's result, an income inclusion from a qualified electing fund will not automatically be treated as passive income for foreign tax credit purposes.

Special rules applicable to both types of funds

Coordination of section 1291 with taxation of shareholders in qualified electing funds

The bill clarifies that the deferred tax and interest charge rules of section 1291 do not apply to any distribution received by a taxpayer from a PFIC if the PFIC is a qualified electing fund for all of its years beginning after 1986 for which it is a PFIC and which include any part of the taxpayer's holding period. This treatment parallels the rule for dispositions provided under the Act.

The bill also modifies the Act's rule that allows a shareholder in a nonqualified fund to elect to recognize the gain inherent in the value of his or her stock owned in the PFIC where the PFIC becomes a qualified electing fund. Under this modification, instead of recognizing the entire gain in the value of his or her stock, a U.S. shareholder in a controlled foreign corporation (as both terms are defined for subpart F purposes) that is a PFIC and that becomes a qualified electing fund can include in gross income as a dividend his or her share of the corporation's earnings and profits accumulated after 1986 and since the corporation was a PFIC. Upon this election, the U.S. shareholder's stock basis is increased by the amount included in income and the shareholder is treated as having a new holding period in his or her stock. Thereafter, the shareholder is subject to the rules applicable to qualified electing funds.

Attribution of ownership

The bill provides that under regulations any person who has an option to acquire stock shall be treated as owning the stock. The committee anticipates that regulations will provide this treatment where necessary to prevent avoidance of the imposition of interest.

Anti-avoidance rule

The bill also provides that under regulations if a U.S. person is treated as owning stock in a PFIC by virtue of the attribution rules, any distribution to the actual holder of the stock is treated as a distribution to the U.S. person. The committee anticipates that regulations will provide this treatment where necessary to prevent avoidance of the imposition of interest. In these cases, the bill also provides that the amounts deemed distributed to the U.S. person are not to be included in gross income of the holder actually receiving those amounts for purposes of causing the U.S. person to include those amounts in income again.

The bill also provides regulatory authority for the Secretary not to treat the pledge of stock in a PFIC as a disposition of that stock. For example, the committee anticipates that regulations may provide that a pledge in effect prior to 1987 shall not be treated as a disposition.

E. Treatment of Foreign Taxpayers

1. Branch profits tax (sec. 6674(q) of the bill, sec. 1241 of the Reform Act, and secs. 26, 861, 884, 906, and 2104 of the Code)

Present Law

Overview

The Act imposed branch-level taxes on profits of foreign corporations operating businesses in the United States and on interest paid or deducted by U.S. businesses operated by foreign corporations. The Act also reduced the U.S. businesses threshold that triggers the withholding tax on dividends paid by foreign corporations (applicable where the branch profits tax cannot be applied).

Branch profits tax

A tax of 30 percent is imposed on a foreign corporation's "divided equivalent amount." The "dividened equivalent amount" is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected (or treated as effectively connected) with a U.S. trade or business, subject to two adjustments (detailed below). The determination of effectively connected earnings and profits is made without reduction for dividend distribution made by a foreign corporation during a year, so that tax is imposed on a foreign corporation that has current earnings (which are not reinvested in a branch's trade or business, as detailed below).

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted in two circumstances. These adjustments identify changes in a branch's U.S. net equity (the difference between a branch's assets that are treated as connected with its U.S. trade or business and its liabilities that are so treated) that reflect profit remittances during a taxable year. The first adjustment to the dividend equivalent amount reduces the tax base to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce trade or business liabilities). This reduction is measured by the increase in the U.S. net equity of the branch: the difference between (1) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the year and (2) the excess of the money and adjusted basis of its assets over its liabilities at the end of the preceding year. The second adjustment increases the tax base to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation. This adjustment is measured by the reduction in the U.S. net equity of the branch: the difference between (1) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the preceding year and (2) the excess of the money and adjusted basis of the branch's assets over its liabilities at the end of the year. The increase in the tax base because of a decrease in U.S. net equity was intended to be limited to the amount of prior earnings that have not been remitted to the home office.

Branch-level interest tax

Interest paid by a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation and, hence, is U.S. source and subject to U.S. withholding tax of 30 percent, unless the tax is reduced or eliminated by a specific Code or treaty provision. It is intended that where this interest is paid to a U.S. person or a U.S. trade or business of a foreign person, the interst is also to be treated as U.S. source but not subject to withholding since it is subject to tax on a net income basis in the hands of the recipient. To the extent a U.S. branch of a foreign corporation has allocated to it under Treasury Regulation section 1.882-5 an interest deduction in excess of the interest actually paid by the branch (this generally occurs where the indebtedness of the U.S. branch is disproportionately small compared to the total indebtedness of the foreign corporation), the excess is treated as if it were interest paid on a notional loan to a U.S. subsidiary (the U.S. branch, in actuality) from its foreign corporate parent (the home office). This excess is also subject to the 30-percent tax, absent a specific Code exemption or treaty reduction.

For purposes of determining whether the tax on the excess interest is to be reduced or eliminated by treaty, the applicable income tax treaty is the one between the United States and the country of the corporation's home office, subject, however, to the prohibition against treaty shopping. In the case of U.S. withholding tax on interest actually paid by a branch to a foreign recipient, the appropriate treaty will be that between the United States and the country of the recipient, subject again to the prohibition against treaty shopping.

Relationship with tax treaties

The Act provides that the branch profits tax is to yield to treaties only in two cases. The first case is where a foreign corporation with a U.S. branch is a "qualified resident" of a country in which the corporation is a resident (i.e., the corporation is not treaty-shopping) and the treaty prohibits the branch profits tax. The second case is where a foreign corporation resides in a country whose treaty permits the United States to impose its withholding tax on dividends paid by the corporation but otherwise prohibits the branch profits tax, whether or not the foreign corporation is treaty shopping. In this second case, however, the foreign corporation paying the dividends cannot claim any treaty benefits (i.e., reduced rates) with respect to the dividends it pays if it is treaty shopping. The Act also prohibited any foreign corporation that receives a dividends from another foreign corporation from claiming any treaty benefits with respect to the dividends received if it is treaty shopping.

A foreign corporation generally is treaty shopping in two cases: First, treaty shopping occurs if more than 50 percent (by value) of the stock of the foreign corporation is owned (determined by looking through corporations, partnerships, estates and trusts to ultimate individual ownership) by individuals who are not residents of the treaty country. U.S. citizens and resident aliens are treated as residents of the treaty country for this purpose.

Second, where 50 percent or more of a foreign corporation's income is used to meet liabilities to persons who are not residents of the country in which the corporation is a resident or of the United States, then the corporation is treaty shopping (a "base erosion" rule).

If a foreign corporation's stock is primarily and regularly traded on an established securities market in the country under whose treaty it claims benefits as a resident, then the corporation is considered a qualified resident of that country. Similarly, if a foreign corporation's parent is organized in the same country as its subsidiary corporation, and the parent corporation's shares are primarly and regularly traded on an established securities market in that country, then the subsidiary corporation is considered a qualified resident of the country for purposes of the country's treaty with the United States. Under the Act, the publicly-traded exception does not auomatically treat a foreign corporation that is wholly owned by a U.S. corporation whose stock is primarily and regularly traded on an established securities market in the United States as a qualified resident of the country in which it is a resident A domestic corporation in this instance has to determine (in addiiton to meeting the base erosion rule) if it is more than 50-percent owned by either U.S. residents or residents of the country of the domestic corporation's subsidiary in order to be treated as a qualified resident.

Other rules

The Act reduced to 25 percent prior law's business income threshold for imposition of the withholding tax on dividends. The Act also provided that the withholding tax on dividends is not applicable where the branch profits tax generally may be imposed, even though no branch tax may be due in a particular taxable year.

For U.S. branches of foreign corporations that have undistributed accumulated earnings and profits as of their first taxable year beginning on or after January 1, 1987, the branch profits tax provisions are intended to apply only to earnings and profits generated in taxable years beginning after December 31, 1986, that are considered distributed from the branch to the home office (limited by post-effective date earnings and profits). Prior law's withholding tax on dividends is intended to apply to the pre-effective date accumulated earnings and profits that are distributed after the effective date. Thus, if a branch's income did not constitute at least 50 percent of the corporation's income for the base period prescribed under prior law, there is no withholding tax imposed on dividends paid in, for example, 1987 that represent pre-effective date earnings. Similarly, pre-effective date deficits in earnings and profits are not intended to be eligible to reduce post-effective date earnings in applying the branch profits tax. Post-effective date deficits in earnings and profits do not reduce pre-effective date earnings in applying prior law's withholding tax to distributions after 1986 where the distributions are attributable to pre-effective date earnings.

Explanation of Provision

Branch profits tax

The bill clarifies that the dividend equivalent amount is limited to the post-1986 accumulated effectively connected earnings and profits of the U.S. branch that have not previously been remitted to the branch's home office.

The bill provides that for purposes of determining a foreign corportion's dividend equivalent amount, effectively connected earnings and profits do not include the increase in earnings and profits under the discounting fresh start provision of the Act (see XXII.C.2. for further discussion of the fresh start provision). Thus, the one-time increase in current earnings and profits of a foreign corporation under that provision will not result in any increase in branch tax. Moreover, the bill excludes from the dividend equivalent amount earnings and profits arising from the adjustment that was required by the Act to the unearned premium reserves outstanding at the end of the most recent taxable year beginning before January 1, 1987 (see X.3. for further discussion of this adjustment).

Branch-level interest tax

The bill clarifies that interest paid or deducted by a U.S. trade or business of a foreign corporation in U.S. source, regardless of the recipient. Thus, if the recipient is a foreign person not engaged in a U.S. trade or business the interest will be subject to U.S. withholding tax; if the recipient is a U.S. person or a foreign person engaged in a U.S. trade or business and the interest is effectively connected therewith, the interest will not be subject to withholding but will be subject to U.S. tax in the hands of the recipient on a net income basis. The bill further clarifies that this source rule applies to interest payments by any foreign corporation that has gross income that is effectively connected with a U.S. trade or business (or is treated as so connected, for example, by an election under sec. 882(d)).

The bill also modifies the taxation of interest paid by a U.S. trade or business. First, the bill excludes interest paid by international organizations (as defined in sec. 7701(a)(18)) from the scope of the provision. Second, to the extent provided in regulations, the bill will limit U.S. withholding to the amount of interest reasonably expected to be deducted in arriving at the branch's effectively connected taxable income.

Relationship with tax treaties

The bill modifies the applicability of the branch profits tax in cases of treaty shopping. This modification provides that if a foreign corporation is treaty shopping, the branch profits tax will be imposed, regardless of whether the treaty with the United States and the country in which the corporation is a resident allows the United States to impose its withholding tax on dividends. One of the reasons Congress enacted the branch profits tax was the difficulty of administering prior law's withholding tax. The Act's rule—prohibiting the imposition of the branch profits tax in cases where a treaty permits the U.S. withholding tax on dividends paid by a foreign corporation whether or not the corporation is treaty shopping—would not in some cases remedy that concern. For example, assume a treaty with the United States prohibits the branch profits tax but it permits the withholding tax on dividends if the corporation derives 50 percent or more of its income from the United States. Assume further that the foreign corporation organized in this treaty country is treaty shopping. The result of the Act would be to impose the withholding tax on dividends in the years in which the corporation derives 50 percent or more of its income from the United States and to impose the branch profits tax in years in which the corporation's U.S. income is below that level. This result would be difficult to administer and would lead to tax avoidance techniques.

More importantly, however, Congress was concerned that foreign persons resident in one country would attempt to use another country's tax treaty with the United States to avoid the branch profits tax. The bill addresses this concern by not allowing treaties to prevail in treaty shopping cases.

The bill clarifies that the prohibition against treaty shopping of recipients of interest paid or deducted by a U.S. trade or business of a foreign corporation applies to any person attempting to claim benefits under the interest articles of the treaty of the country in which the foreign corporation is a resident. The bill continues to allows, however, the recipient to claim benefits under the treaty in the country in which the recipient is a resident, unless the recipient is treaty shopping as well.

The bill modifies the definition of treaty shopping in two respects. First, the bill provides that if nonresidents of a treaty country own *50 percent or more* of the value of stock of a corporation the corporation is considered treaty shopping. This modification generally accords with the ownership limitation in recent U.S. income tax treaties. Second, the bill modifies the publicly traded exception to treaty shopping to provide that a foreign corporation that is wholly owned by a domestic corporation whose stock is primarily and regularly traded on an established securities market in the United States is to be treated as a qualified resident of its country of residence. This modification accords with the Act's presumption that corporations whose stock is primarily and regularly traded on a local securities market is more than 50 percent owned by local residents and with the Act's treatment of U.S. persons as treaty-country residents.

Other rules

The bill clarifies that the withholding tax on dividends is not imposed for any taxable year with respect to dividends paid out of earnings and profits of the corporation for that year if the branch profits tax may be imposed for that year (even if no branch profits tax may be due in that year). Thus, the withholding tax on dividends may be imposed in two cases. First, the withholding tax may be imposed on dividends that are attributable to pre-1987 earnings and profits. Second, the withholding tax may be imposed on dividends that are attributable to any earnings and profits when the branch profits tax is prohibited by a treaty with the United States, regardless of when the dividends are distributed. Thus, in this latter case, the withholding tax on dividends may be imposed in a year a foreign corporation is subject to the branch profits tax if the dividends are attributable to years in which the branch tax is prohibited, for example, by a treaty.

2. Treatment of deferred payments and appreciation arising out of business conducted within the United States (sec. 6674(r) of the bill, sec. 1242 of the Reform Act, and sec. 864(c) of the Code)

Present Law

The Act provides that any income or gain of a nonresident alien individual or foreign corporation for any taxable year which is attributable to a sale or exchange of property, the performance of services, or any other transaction, in any other taxable year shall be treated as effectively connected with the conduct of a trade or business within the United States if it would have been so treated if such income or gain were taken into account in such other taxable year (new Code sec. 864(c)(6)). Similarly, the Act provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of such property occurring within 10 years after such cessation is effectively connected with the conduct of a trade or business within the United States shall be made as if such sale or exchange occurred immediately before such cessation (new Code sec. 864(c)(7)). Under the Act, the amount of income or gain taken into account under the latter provision is not limited to the appreciation of the property while the property was used in the United States, but rather is based on the amount of income or gain recognized at the time of the sale or exchange.

A foreign corporation engaged in a trade or business during the taxable year is taxable on a net basis on its income which is effectively connected with the conduct of a trade or business within the United States (Code sec. 882(a)). The same treatment applies to nonresident alien individuals (Code sec. 871(b)).

Explanation of Provision

In the case of payments for sales or exchanges of property, the performance of services, or any other transaction, that are deferred from one taxable year to a later taxable year, the determination whether such income or gain is taxable on a net basis (under sec. 871(b) or 882(a)) is to be made as if the income were taken into account in the earlier year and without regard to the requirement (of sec. 871(b) or 882(a)) that the taxpayer be engaged in a trade or business within the United States during the later taxable year. The bill makes a similar amendment to the Act's provision taxing dispositions of property formerly used or held for use in connection with the conduct of a trade or business within the United States and disposed of within 10 years after that cessation of use. For this purpose, the property is treated as being sold or exchanged immediately before it ceased to be used or held for use in connection with the conduct of a trade or business in the United States, and the requirement (of sec. 871(b) or 882(a)) that the taxpayer be engaged in a trade or business within the United States during the taxable year for which such income or gain is taken into account is disregarded.

3. Withholding tax on amounts paid by partnerships to foreign partners (sec. 6674(s) of the bill, sec. 1246 of the Reform Act, and secs. 872, 882, and 1446 of the Code)

Present Law

Partnership withholding

Prior to the Act, partnerships that conducted a trade or business in the United States generally were not required to withhold U.S. tax on distributions to foreign persons that were attributable to the U.S. business income of the partnership. Under the Act, however, partnerships must withhold in these circumstances. This withholding requirement supplements other withholding requirements applicable to certain generally passive types of U.S. source income derived by partnerships that have foreign partners.

Under the Act, the following withholding rules apply to distributions to foreign partners in U.S. or foreign partnerships that have any income effectively connected with the conduct of a U.S. trade or business. First, withholding at 30 percent (sometimes reduced or eliminated under treaties) is required with respect to distributions attributable to certain U.S. source fixed or determinable annual or periodic income not effectively connected with the conduct of a U.S. trade or business. It is intended that any distribution by the partnership be considered to come first out of these types of income received by the partnership.

Second, any partnership distribution in excess of the amounts described immediately above is subject to withholding at a 20-percent rate. The amount withheld is creditable against the U.S. income tax liability of the foreign partner. Amounts withheld in excess of a foreign person's tax liability are treated as an overpayment of tax.

Third, if a partnership's gross income effectively connected with a U.S. trade or business over a three-year period (or shorter period if the partnership is not in existence for three years) is less than 80 percent of the total gross income of the partnership over that period, then withholding is required only on the proportion of current distributions that the partnership's gross income effectively connected with its U.S. trade or business bears to the partnership's total gross income over its previous three taxable years (or shorter period if the partnership is not in existence for three years).

Fourth, the Act provides that, unless otherwise provided in regulations, withholding is not required if substantially all of the U.S. source income and substantially all of the income effectively connected with a partnership's U.S. trade or business is allocable to U.S. partners pursuant to a valid special allocation under section 704(b) and the regulations thereunder. This provision exempting amounts from withholding is not intended to apply to a partnership which has only U.S. source income and in which foreign persons hold only a minority interest such that, on a straight allocation, "substantially all" of the partnership's income could be considered to be allocated to U.S. persons. Instead, it is intended to apply only to a partnership which specially allocates its U.S. source income to U.S. persons and its foreign source income to foreign persons.

Taxation of foreign persons

Nonresident alien individuals and foreign corporations generally are subject to U.S. tax only on their gross income which is derived from U.S. sources and which is not effectively connected with the conduct of a trade or business in the United States and on their gross income which is effectively connected with the conduct of a trade or business in the United States (secs. 872(a) and 882(b)). United States tax on the former type of gross income generally is collected by withholding whereas U.S. tax on the latter type of gross income generally is collected by the filing of a U.S. tax return and payment of estimated taxes.

Explanation of Provision

Partnership withholding

The bill modifies the rule that requires withholding only on a proportion of current distributions by a partnership if the partnership's gross income effectively connected with its U.S. trade or business is less than 80 percent of the partnership's total gross income. For this purpose, gross income, the denominator of the fraction, does not include any U.S. source fixed or determinable annual or periodical income (i.e., income that is described in sec. 1441(b)) which is not effectively connected with the conduct of the partnership's U.S. trade or business.

The bill also modifies the Act's coordination of the 20-percent withholding rule with the Code's other withholding rules. This modification requires regulations to prescribe rules to adjust the amounts withheld from partnership distributions in order to account for partnership income subject to the regular 30 percent (or reduced treaty rate) withholding rules and the FIRPTA withholding rules, and to account for partnership income not subject to U.S. tax (for example, certain capital gain income). Whereas the Act's legislative history adopted a tracing approach in coordinating these rules, the committee anticipates that the regulations will instead adopt a fungibility approach to coordinate the different rules.

The bill clarifies the exception to 20-percent withholding for partnerships with certain special allocations of partnerships' distributive shares. This clarification provides that the exception applies only to a partnership which specially allocates its U.S. income to U.S. persons and its foreign income to foreign persons.

Taxation of foreign persons

The bill clarifies the meaning of gross income for nonresident alien individuals and foreign corporations. Under the bill, sections 872(a) and 882(b) are modified so that, for those persons, unless the context clearly indicates otherwise, gross income includes only gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States, and gross income which is effectively connected with the conduct of a trade or business within the United States. For example, when the taxpayer at issue is a nonresident alien individual or a foreign corporation, gross income subject to direct U.S. income tax includes only that gross income which is derived from U.S. sources and which is not effectively connected with the conduct of a U.S. trade or business and that gross income which is effectively connected with the conduct of a U.S. trade or business. By contrast, a partnership's gross income, for purposes of determining the proportion of distributions by a partnership that is subject to 20 percent withholding, is all income from whatever source derived (as determined under sec. 61), except as specifically modified by the change described above. Thus, a partnership's gross income will include its gross income derived from foreign operations in addition to that gross income derived from its U.S. operations.

4. Income of foreign governments (sec. 6674(t) of the bill, sec. 1247 of the Reform Act, and sec. 892 and 893 of the Code)

Present Law

The Act provides that the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments is not included in gross income and is exempt from income taxation (Code sec. 892). In addition, the Act provides that the exemption does not apply to any income received from or by a controlled commercial entity. The Act's legislative history indicates that, for treaty purposes, a foreign government is to be treated as a resident of its country, unless it denies similar treaty benefits to the United States.

In certain cases, wages, fees, or salary of an employee of a foreign government received as compensation for official services to such government is excluded from gross income and is exempt from income taxation (Code sec. 893).

Explanation of Provision

The bill makes it clear that the Code provision benefiting certain income of foreign governments (sec. 892) neither excludes from gross income nor exempts from tax income derived from the disposition of any interest in a controlled commercial entity. Thus, this Code provision does not benefit such income, whether or not such income is received from investments in the United States in stocks, bonds, or other domestic securities owned by a foreign government. Such income may not be taxable for independent reasons: for example, a sale of stock of a U.S. corporation that is not a U.S. real property interest by a foreign person may not be subject to tax under general Code rules. For this purpose, however, a commercial entity is to include any U.S. real property holding corporation (Code sec. 897(c)(2)).

In addition, the bill clarifies that the Code's exclusion from gross income and exemption from taxation do not apply to income received indirectly from a controlled commercial entity (as well as to income received directly from such an entity). For example, assume that a foreign government owns all the shares of a U.S. operating company that owns all the shares of a U.S. operating company. The U.S. holding company deducts all the dividends it receives from the operating company by virtue of the 100-percent dividends received deduction. Under the bill, dividends from the holding company to the foreign government are not exempt, because they are received indirectly from a controlled commercial entity.

The bill codifies the rule that a foreign government, for income tax treaty purposes, is treated as a corporate resident of its country if it grants equivalent treatment to the U.S. government. In addition, for purposes of the Internal Revenue Code, a foreign government is treated as a corporate resident of its country (whether or not it treats the U.S. government as a U.S. resident).

The bill conforms the gross income exclusion and tax exemption for wages, fees, or salary of an employee of a foreign government to the exclusion and exemption for governments themselves. Under the bill, the exclusion and exemption are not available to an employee of a foreign government whose services are primarily in connection with a commercial activity (whether within or outside the United States) of the foreign government, or to any employee of a controlled commercial entity of a foreign government.

5. Dual residence companies (sec. 6674(u) of the bill, sec. 1249 of the Reform Act, and sec. 1503 of the Code)

Present Law

The Act provides that if a U.S. corporation is subject to a foreign country's tax on worldwide income, or on a residence basis as opposed to a source basis, any net operating loss it incurs cannot reduce the taxable income of any other member of a U.S. affiliated group for that or any other taxable year. A net operating loss of such a company is referred to as a "dual consolidated loss." Regulatory authority is provided to exclude a loss from the ambit of this rule to the extent that that loss does not offset the income of foreign corporations for foreign tax purposes.

Explanation of Provision

The bill provides that, to the extent provided in regulations, any loss of any separate and clearly identifiable unit of a trade or business of the taxpayer is to be treated as a dual consolidated loss as if that unit were a wholly owned subsidiary of that corporation. For example, assume that a U.S. corporation maintains a branch in a foreign country. That foreign country allows the loss of that branch to offset the taxable income of a locally incorporated corporation that is wholly owned by the U.S. corporation (or an affiliate of the U.S. corporation). The branch incurs, for both U.S. and foreign tax purposes, a net operating loss of $100. The foreign corporation earns income of $100. The U.S. corporation, viewed as a whole, has neither gain nor loss for the year: the $100 loss of the branch offsets $100 of income generated by the rest of the U.S. corporation. Under the bill, regulations may provide that the branch's $100 loss is treated as a dual consolidated loss. It is anticipated that regulations will so provide to the extent that the branch's loss offsets the income of a foreign corporation for foreign purposes. In that case, that loss may not be used to offset the income that the U.S. corporation earns other than from the branch operation. Thus, the taxable income of the U.S. corporation is $100. The branch's $100 loss is available for carryforward against future income of the branch.

F. Foreign Currency Exchange Rate Gains and Losses (Sec. 6674(v) of the bill, Sec. 1261 of the Reform Act, and Secs. 986-989 of the Code)

1. Foreign currency translation

Present Law

Translation of foreign income taxes

Subpart J of the Code, as added by the Act, provides rules for the translation of foreign income taxes that enter into various computations involving the foreign tax credit. Foreign income taxes are defined for purposes of subpart J as any income, war profits, or excess profits taxes paid to any foreign country or any possession of the United States. For foreign tax credit and foreign tax deduction purposes, income, war profits, and excess profits taxes include a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

Generally for purposes of computing either the direct or indirect foreign tax credit, the amount of foreign income taxes paid to a foreign government of U.S. possession is translated, under subpart J, using the exchange rate in effect as of the time of payment; any refund or credit of a foreign income tax is translated using the exchange rate in effect as of the time of the original payment; and any increase in the amount of a foreign income tax is intended to be translated using the exchange rate in effect when the increase is paid. (Congress did not intend the payment date rule to prevent the allowance of a credit based on accrued foreign taxes where those taxes are unpaid when the credit must be computed).

Translation of section 956 income inclusions

On the actual distribution of earnings and profits from a foreign corporation to a U.S. taxpayer, the latter is required to translate such amounts (if necessary) at the current exchange rate on the date the distribution is included in income. In the case of deemed distributions under section 951(a) of subpart F, the required income inclusion is first calculated in the functional currency and then translated at the weighted average exchange rate for the foreign corporation's taxable year. The Secretary may adjust these translation rates by regulation.

Where earnings of a controlled foreign corporation are repartriated, the Code generally aims at achieving similar tax results whether the repatriation is in the form of a dividend or of an increase in investment in U.S. property (*see* secs. 951(a)(1)(B) and 956). However, the translation rules described above provide for computing translation rates differently depending on the form of repatriation. Congress did not intend to provide taxpayers their choice of tax results based on translation method where a similar economic result is achieved in either case.

Explanation of Provisions

Translation of foreign income taxes

The bill clarifies that in applying the foreign income tax translation rules of new subpart J (as well as the other foreign provisions of the Code), foreign taxes imposed in lieu of income taxes are treated the same as foreign income taxes.

The bill also clarifies that the exchange reate to be used for determining the dollar cost of any payument of foreign income tax (including a payment consitituting an adjustment to a payment of foreign tax) is the exchange rate as of the time the taxes are paid to the foreign country or U.S. possession. The bill applies this rule whether the entity paying the tax to the foreign government or U.S. possession is the taxpayer or (as in the case where the taxpayer claims an indirect foreign tax credit) a corporation of which the taxpayer is a shareholder, and whether or not the tax is paid by a qualified business unit.

Translation of section 956 income inclusions

The bill provides that subpart F inclusions under section 951(a)(1)(B), relating to increases in investments in U.S. property, are to be translated at the same rates as actual distributions made on the last day of the taxable year, i.e., using the spot rate on that day. This reduces the opportunity for taxpayers to manipulate tax liability based on the foreseeable difference between the weighted average annual rate and the spot rate as of the date when earnings repatriation is to occur. The Secretary retains authority to further adjust translation rates, under regulations, where regulatory adjustments can usefully promote the aim of reducing similar opportunities for manipulation.

2. Foreign currency transactions

Present Law

Exclusion from section 988 treatment for 1256 contracts

Section 988(c) defines the term "section 988 transaction" to include, among other things, (1) the acquisition of (or becoming the obligor under) a debt instrument, (2) the disposition of nonfunctional currency, and (3) entering into or acquiring any forward contract, option, or similar financial instrument (such as a currency swap), if such instrument is not marked to market at the close of the taxable year under section 1256. Congress did not intend to change generally the treatment of bank forward contracts, regulated futures contracts, or other contracts subject to the mark-to-market rule under section 1256. Therefore, Congress intended to exclude such instruments from the definition of a section 988 transaction.

Measurement and recognition of foreign currency gain or loss

Section 988(b) defines foreign currency gain or loss as gain or loss on a section 988 transaction, but only to the extent the gain or loss is realized by reason of a change in exchange rates between the booking date with respect to that transaction and the payment date of the transaction. In the case of any disposition of nonfunctional currency, the relevant period for measuring rate changes is the time between acquisition and disposition of the currency.

For transactions involving forward contracts or similar positions, the booking date is the date on which the position is entered into or acquired; the payment date includes the date on which a taxpayer's rights are terminated with respect to the position (e.g., by entering into an offsetting position). The definition of foreign currency gain or loss is intended to apply to gain or loss attributable to exchange rate movements between those dates affecting the value of forward contracts or similar instruments, regardless of the particular transaction in which the gain or loss is realized.

The Secretary has general authority to provide the regulations necessary or appropriate to carry out the purposes of new subpart J. For example, where a debt instrument, the acquisition of which is a section 988 transaction, is converted to stock, the sale of which is not a section 988 transaction, the Act gives the Secretary the authority to prevent any foreign currency gain inherent in the debt instrument from escaping subpart J treatment.

Section 988 hedging transactions

The Act authorizes the issuance of regulations that address the treatment of transactions that are part of a section 988 hedging transaction. To the extent provided in regulations, in the case of any transaction giving rise to foreign currency gain or loss that is part of a section 988 hedging transaction (determined without regard to whether any position in the hedge would be marked to market under section 1256), all positions in the hedging transaction are integrated and treated as a single transaction, or otherwise treated consistently (e.g., for purposes of characterizing the nature of income or the sourcing rules). In the case of a foreign currency borrowing fully hedged with a series of forward purchase contracts, for example, Congress intended that regulations treat the entire package as a dollar borrowing with dollar interest payments subject to the rules of section 1271 et seq. and 163(e) for determining the appropriate interest deduction.

Sourcing rules

In general, foreign currency gain is sourced, and foreign currency losses are allocated, by reference to the residence of the taxpayer or qualified business unit on whose books the underlying financial asset or liability is properly reflected. For purposes of these rules, an individual's residence is defined as the country in which the "tax home" (as defined in sec. 911(d)(3)) is located. The residence of any U.S. person (as defined in sec. 7701(a)(30)) other than an individual is the United States. In the case of a foreign corporation, partnership, trust, or estate, the residence is treated as a foreign country.

The Secretary has authority to prescribe regulations carrying out the purposes of the Act's currency sourcing provisions as well as regulatory authority under the rules introduced by the Act for determining generally the source of income derived from the sale of personal property. Under the latter it was contemplated that regulations may be required to prevent persons from establishing partnerships or corporations, for example, to change their residence to take advantage of the new rules. It was anticipated that the establishment of an anti-abuse rule to treat, for example, a foreign partnership as a U.S. resident to the extent its partners are U.S. persons would be appropriate.

Explanation of Provisions

Exclusion from section 988 treatment for 1256 contracts

The bill provides that if a forward contract, futures contract, option, or similar financial instrument would have been marked to market under section 1256 were it held on the last day of the taxable year, then the instrument is not a "section 988 transaction" even if it is not actually marked to market under section 1256 *at the close of the taxable year.* This amendment clarifies that taxpayers who acquire 1256 contracts cannot elect 988 rules for characterizing, timing, and sourcing or allocating the income or loss on such contracts simply by disposing of the contracts prior to the last day of the taxable year.

Measurement and recognition of foreign currency gain or loss

The bill provides that any gain or loss from a section 988 transaction is a foreign currency gain or loss if the transaction is a disposition of nonfunctional currency or a forward contract, futures contract, option, or similar financial instrument with respect to a nonfunctional currency. This makes it clear that any gain or loss on such an instrument due to forward premium or forward discount is subject to the Act's rules for foreign currency gains and losses, regardless of movements in the spot rates of exchange between the booking and payment dates. Further, any gain or loss on a nonfunctional currency disposition is foreign currency gain or loss regardless of whether the difference between acquisition and disposition prices is due to spot rate movements between acquisition and disposition dates, forward discount or premium, bid-asked spreads, or other factors.

The bill provides that making or taking delivery under a section 988 transaction that is a forward contract, futures contract, option, or similar financial instrument is a gain or loss recognition event (*cf.* sec. 1256(c)). This rule prevents taxpayers from opting for alternate treatment on such a transaction by selling or otherwise closing out the position, on the one hand, or taking or making delivery, on the other. Under a transitional provision, this rule will not change the treatment of deliveries taken by a taxpayer on or before the date of the bill's introduction.

Where a forward contract, futures contract, option, or similar fiancial instrument gives its owner the right to make or take multiple deliveries of currency at different times during the life of the instrument, the committee intends that the bill's recognition rule will generally treat the taxpayer as having sold an instrument representing that portion of the rights exercised at the time a particular delivery under the instrument is made or taken. It is anticipated that the Secretary will exercise his regulatory authority under subpart J to provide rules for the allocation of any basis in the instrument for these purposes, to prevent the artificial acceleration of loss in such a case, and to impose any other requirements necessary or appropriate to carry out the purposes of the bill's recognition rule.

Section 988 hedging transactions

The bill provides that where all transactions that are part of a section 988 hedging transaction are integrated and treated as a single transaction or otherwise treated consistently under regulations, such treatment applies for purposes of all provisions in subtitle A of the Code. Thus the bill makes clear Congress' intent that Code provisions other than section 988 are to be applied to the components of a section 988 hedging transaction in their integrated or otherwise combined state (where regulations provide for such integration or combination).

Sourcing rules

For purposes of the currency sourcing rules as well as the general source rules for income derived from the sale of personal property, the bill treats any U.S. citizen or resident alien as a U.S. resident if he or she does not have a tax home in a foreign country. Thus the bill prevents such an individual from being treated as a nonresident if he or she has no tax home (which may be the case, for example, for a traveling salesperson).

The bill also clarifies that the Secretary's regulatory authority to determine the source of foreign currency gains encompasses authority to determine the source of a partnership's foreign currency gains by reference to the residence of the partners. The committee anticipates that this authority will be exercised where necessary to prevent persons from establishing partnerships to change their residence to take advantage of the new rules.

G. Tax Treatment of Possessions (Sec. 6674(w)-(z) of the bill, Secs. 1274-1277 of the Reform Act, and Sec. 932 of the Code)

Present Law

Mirroring of Virgin Islands coordination rule

The Act contains a new provision coordinating U.S. and Virgin Islands income taxes (Code sec. 932). That Code section does not apply for purposes of determining income tax liability incurred to the Virgin Islands. The intent of Congress in not having that provision apply for V.I. tax purposes was to prevent any argument that 48 U.S.C. 1397 (the provision of the Naval Appropriations Act of 1922 that holds the U.S. Income tax laws, as amended, to be "likewise in force in the Virgin Islands") or the Revised Organic Act of the Virgin Islands could require "mirroring" of the new coordination provision for internal Virgin Islands purposes.

Treatment of Virgin Islands residents

The Act provides that in the case of an individual who is a bona fide resident of the Virgin Islands at the close of the taxable year and who, on his or her return of income tax to the Virgin Islands, reports income from all sources and identifies the source of each item shown on such return, for purposes of calculating income tax liability to the United States, gross income shall not include any amount included in gross income on the V.I. return. The Act indicates that such an individual is to file his income tax return with the Virgin Islands.

Effective date of prohibition of branch tax

The provisions of the Act applicable to Guam, American Samoa, and the Northern Mariana Islands generally apply only if and so long as an implementing agreement under Act section 1271 is in effect between the United States and such possession. The Act provides that for certain corporations created or organized in Guam, American Samoa, the Northern Mariana Islands, or the Virgin Islands, the branch tax does not apply. This provision is to be mirrored, so that the branch tax does not apply to U.S. corporations with operations in any of those possessions.

Explanation of Provisions

Mirroring of Virgin Islands coordination rule

The bill provides that in applying Code section 932 (the provision coordinating U.S. and Virgin Islands income taxes) for purposes of determining income tax liability incurred to the Virgin Islands, the provisions of Code section 932 are not to be affected by any provision of Federal law described in Code section 934(a), i.e., the Naval Appropriations Act or the Revised Organic Act. Thus, while there is not to be "mirroring" of this provision, this provision, insofar as it determines the taxable income of Virgin Islands residents, has effect for V.I. tax purposes.

Treatment of Virgin Island residents

The bill adds to the bona fide resident requirement and the reporting requirement a third requirement for exclusion of items reported on a V.I. return. That further requirement is that the individual seeking the exclusion fully pay his or her tax liability (referred to in sec. 934(a)) to the Virgin Islands with respect to income from all sources. In addition, the bill provides that in the case of an individual whose gross income excludes amounts included on a V.I. return, allocable deductions and credits are not to be taken into account. The bill also makes it clear that such an individual is to file "an" income tax return with the Virgin Islands, rather than filing, "his" return with the Virgin Islands, to make it clear that individuals who do not comply with all requirements for U.S. tax exemption will have to file a U.S. return.

Effective date of prohibition of branch tax

The bill makes it clear that the rule prohibiting the imposition of the branch tax on certain corporations organized in the possessions (and thus the prohibition of imposition of the branch tax by a possession on a U.S. corporation) applies for taxable years beginning after December 31, 1986.

H. Miscellaneous Foreign Provisions

1. Relationship with treaties (sec. 6674(aa) of the bill, Title VII and Title XII of the Reform Act, and sec. 7852 of the Code)

Present Law

In general, when a statute and a treaty provision conflict, the one adopted later controls. When Congress enacted the Internal Revenue Code of 1954, it included in that Code (sec. 7852(d)) a statement that no provision of the Internal Revenue title, *i.e.*, the Internal Revenue Code, was to apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of the 1954 Code (August 16, 1954). The intent of that provision was to provide a transitional rule to ensure that the substitution of the 1954 Code for the preexisting 1939 Code did not operate to override then-exisiting treaty provisions. A House bill provision amending Code section 7852(d) to reflect that intent—that post-1954 statutory changes not yield to pre-1954 treaties—was inadvertently dropped in the 1986 Tax Reform Act.

In a number of respects, the Act (and its legislative history) did not specifically address its interaction with U.S. treaties. Many recent tax Acts by contrast, have specifically addressed interaction with treaties. "[I]n the interest of forestalling any possible litigation," the Revenue Act of 1962 expressly provided that it took precedence over any prior treaty obligation (H.R. Rep. No. 1447, 87th Cong., 2d Sess. 96 (1962); Pub. L. No. 87-834, sec. 31). One major conflict between that Act and treaties, not identified in the legislative history of that Act, was the conflict between the Act's separate foreign tax credit limitation for interest income and treaties that (at least literally) required the United States to retain the foreign tax credit limitation rules that it used at some earlier date.

The Foreign Investors Tax Act of 1966 took the opposite approach. Although that Act reduced the burdens of foreign investors and thus no treaty violations were found, the Act (sec. 110) specifically provided that it did not apply in any case where its application would be contrary to any U.S. treaty obligation. In more recent years, Congress has specifically indicated that it intended that tax Acts prevail over treaties in the case of conflicts. Congress took this approach with respect to the foreign tax credit changes in the Tax Reform Act of 1976 (H.R. Rep. No. 94-658, 94th Cong., 2d Sess. 226 (1975); S. Rep. No. 94-938, 94th Cong., 2d Sess. 237 (1976)) and with respect to the Crude Oil Windfall Profit Tax Act of 1980 (H.R. Rep. No. 96-817, 96th Cong., 2d Sess. 106 (1980) (conference report)). In connection with the Deficit Reduction Act of 1984, Congress resolved certain conflicts in favor of treaties but indicated that, in the event of unidentified treaty conflicts, the legislation is to prevail (see description of technical corrections made to the 1984 Act by the 1986 Act, H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 917 (1985); S. Rep. No. 99-313, 99th Cong., 2d Sess. 935 (1986)).

Explanation of Provision

The bill modifies the 1954 transition rule (embodied in Code sec. 7852(d)) governing the relationship between treaties and the Code to clarify that it does not prevent application of the general rule providing that the later in time of a statute or a treaty controls (Code sec. 7852(d)). The bill provides that no provision of the Internal Revenue title that was in effect on August 16, 1954, shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of the 1954 Code (August 16, 1954). This provision makes it clear that treaty provisions that were in effect in 1954 and that conflict with the 1954 Code as originally enacted are to prevail over then-existing statutes but not over later-enacted statutes.

The bill clarifies that interaction between the 1986 Act and provisions of U.S. treaties. The bill provides that the following provisions of the 1986 Act will not apply to the extent that their application would be contrary to any income tax treaty obligation of the United States in effect on the date of enactment of the 1986 Act (October 22, 1986): section 123 of the Act (imposing tax on certain scholarship and fellowship grants); subsections (b) and (c) of section 1212 of the Act (imposing a 4-percent gross withholding tax on certain transportation income earned by foreign persons and amending the rules that allow a reciprocal exemption for certain transportation income earned by foreign persons); section 1247 of the Act (relating to the exemption that the United States provides to foreign governments in some cases); and section 1242 of the Act insofar as it relates to new Code section 864(c)(7) (treating gain from sale of assets used in a U.S. trade or business as effectively connected income after cessation of the trade or business in certain cases). In addition, in the event of conflict with an income tax treaty, the source rules of section 1212(a) of the Act (governing the source of certain transportation income) and of section 1214 of the

Act (governing the source of payments from 80/20 companies) will not apply except for purposes of the foreign tax credit limitation. Further, the provisions of section 1241 of the Act that relate to new Code section 884(f)(1)(A) (to the extent that that provision treats interest paid in excess of interest deducted as U.S. source) and to Code section 861(a)(2)(B) (reducing the fraction of U.S. income that exposes a foreign corporation to U.S. withholding tax on dividend payments it makes) will not apply in the event of a treaty conflict. In addition, in the event of conflict with an income tax treaty, the source rules of section 1211 of the Act (determining the source of income from certain sales of personal property) will not apply to individuals treated as residents of a treaty country under a U.S. treaty.

Moreover, to the extent that the source rule of section 865(e)(2) conflicts with a U.S. income tax treaty, the bill provides that the treaty will prevail. A conflict may arise with this source rule because, under the Act, income derived by a foreign person from the sale of inventory property that is attributable to a U.S. office is U.S. source. This result occurs even though the sale may occur outside the United States and a foreign country may tax the sale on a source basis. By contrast, a U.S. resident who sells inventory property outside the United States may not pay any U.S. tax on the income because the income is considered foreign source. Thus, the nonresident may incur more burdensome taxation than a similarly situated U.S. resident. If this occurs, the bill allows a nonresident with nondiscrimination protection to treat this income as foreign source.

Moreover, the bill provides that the Act's imposition of tax in certain cases on "excess interest" (i.e., the amount of a foreign corporation's U.S. interest deduction in excess of the amount of interest its U.S. trade or business has paid) will not apply in the event of a treaty conflict. The committee also considered but did not adopt a substitute for the tax on excess interest that would generally have complied with U.S. treaty obligations: treatment of interest paid by foreign corporations as U.S. source to the extent of the U.S. deduction claimed by the payor. The committee noted that adoption of this substitute would have made it difficult for foreign corporations to compute and withhold this tax. The committee believes that it would be appropriate to study this substitute and other proposals designed to match, in the case of any interest payment or accrual, the U.S. interest expense deduction with the U.S. interest income inclusion.

The bill's amendment to Act section 1211, described in section B.1. above, provide a coordination rule for cases where sales of stock and certain intangibles yield foreign source income under an income tax treaty and U.S. source income under new Code section 865.

The bill provides that the following provisions of the 1986 Act will apply notwithstanding any treaty provision in effect on the date of enactment of the 1986 Act (October 22, 1986): section 1201 of the Act, amending the foreign tax credit limitation, and section 701 of the Act (as it relates to the limitation on the use of foreign tax credits against minimum tax liability).

Except for cases that have been identified in the bill or in the Act, no cases are known where a harmonious reading of the Act and U.S. treaties is not possible. It is understood that Congress intended harmonious construction of the Act and U.S. income tax treaties to the extent possible. Thus, in some cases, despite the existence of technical arguments alleging the existence of a conflict, it is understood that no conflict exists. For example, it is understood that no nondiscrimination provision of any U.S. treaty bars the application of reasonable collection mechanisms designed to ensure the collection of a tax, the imposition of which is permitted by the treaty. Thus, it is understood that the Act's partnership withholding provision (new Code sec. 1446), which is refundable in appropriate cases, constitutes such a reasonable collection mechnism, and thus is fully consistent with existing U.S. treaty obligations.

Similarly, it is understood that the Act's imposition of tax on installment gains received after a foreign person ceases a U.S. trade or business (Act section 1242) is fully consistent with existing U.S. treaty obligations. Some treaties prevent imposition of U.S. tax on business profits of a foreign person unless those profits are attributable to a permanent establishment through which the foreign person carries on business in the United States. It is understood that these treaties do not prevent imposition of U.S. tax on income that was, when realized, attributable to a permanent establishment, even though that income is recognized after the permanent establishment no longer exists. Under a similar analysis, it is understood that the Act creates no conflict with treaties in taxing amounts earned for personal services in the United States which are paid after the person earning the income no longer maintains a U.S. presence.

Other Act provisions that are understood to be fully consistent with U.S. treaty obligations include the Act's dual residence company provisions (Act sec. 1249).

Similarly, requiring recognition of gain by a domestic corporation that is liquidating into a foreign parent corporation or engaging in a tax-free reorganization where the domestic corporation's assets are being removed from U.S. taxing jurisdiction does not violate any nondiscrimination clause. In come cases, provisions based on capital ownership prohibit imposition of more burdensome taxes on foreign-owned U.S. enterprises than on similar U.S.-owned U.S. enterprises. For this purpose, however, a U.S. enterprise transferring assets to a shareholder who will bear U.S. corporate level tax on the income generated by those assets is not similar to a U.S. enterprise transferring assets to a shareholder who will not bear U.S. corporate level tax on the income generated by those assets. Thus, the Act's provision recognizing gain in these case (sec. 631(d)), and the bill's provision making modifications thereto, are fully consistent with U.S. treaty obligations. Nonetheless, in view of an Internal Revenue Service announcement (subsequently withdrawn) indicating that certain liquidations were treaty-protected, the committee intends that the Reform Act's amendments to section 367(e)(2) of the Code not apply in the case of a corporation completely liquidated into a treaty-country parent before June 10, 1987, the date of the bill's introduction.

If, in any of the cases described above where conflicts are understood not to exist, any treaty is somehow read to bar operation of the Act, the Act is to be effective notwithstanding the treaty.

Notwithstanding Congress' intent that the Act and income tax treaties be construed harmoniously to the extent possible, conflicts other than those addressed in this bill or in the Act ultimately may be found to exist. Therefore, the bill provides that except as otherwise provided by the bill or the Act, the provisions of the 1986 Act will apply notwithstanding any treaty provision in effect on the date of enactment of the 1986 Act (October 22, 1986). If any such now-unknown conflict is ultimately found, it is expected that full legislative consideration of that conflict will take place to determine whether application of the general later-in-time rule is appropriate.

In addition, except as indicated in this bill or in other portions of this legislative history, the tax provisions of this bill (including this technical corrections title) are understood not to conflict with any treaty. Again, should a conflict ultimately appear, the bill's tax provisions are to take effect.

2. Foreign personal holding companies (sec. 6674(bb)(1) of the bill, sec. 1810(h) of the Reform Act, and secs. 551 and 552 of the Code)

Present Law

Estates and trusts owning shares of foreign personal holding companies

United States shareholders in a foreign personal holding company (FPHC) are subject to current U.S. tax on their pro rata share of the company's undistributed FPHC income. The FPHC rules were enacted in 1937 to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorproated pocketbooks."

In 1937 there was no statutory definition distinguishing estates and trusts that were U.S. taxpayers (for revenue act purposes in general) from those that were not. For purposes of the FPHC rules, an estate or trust was considered a "U.S. shareholder" in an FPHC unless gross income of the estate or trust for federal income tax purposes included only income from U.S. sources. Subsequently the Code was amended to include generally applicable definitions of the terms "foreign estate" and "foreign trust." (Under current law, these terms mean an estate or trust, as the case may be, the income of which, from sources outside the United States which is not effectively connected with a U.S. trade or business, is not includible in gross income under the Code's income tax provisions (sec. 7701(a)(31)).)

The foreign personal holding company rules contain a tracing rule, added by the Tax Reform Act of 1984, to make it clear that U.S. taxpayers cannot avoid the FPHC rules by interposing foreign entities between themselves and a FPHC. The 1984 Act grants regulatory authority to the Secretary of the Treasury to provide for such adjustments in the FPHC rules as may be necessary to carry out the purposes of this tracing rule. The 1986 Act included a technical amendment to the tracing rule to clarify that the tracing rule applies to all foreign trusts and estates (as defined for Code purposes generally) interposed between U.S. taxpayers and FPHCs.

Same country dividend and interest exception

The 1984 Act provided that dividends and interests received by a foreign corporation from a person (1) related to the recipient, (2) organized in the same country as the recipient corporation, and (3) having a substantial part of its assets used in its trade or business located in that same country, generally do not count in either the numerator or the denominator of the fraction that is used in determining whether the foreign corporation is the FPHC. The 1986 Act provided a definition of related person for this purpose.

Explanation of Provisions

Estates and trusts owning shares of foreign personal holding companies

Under the bill, estates and trusts that are shareholders in an FPHC are U.S. shareholders for purposes of the FPHC rules unless they are foreign estates or trusts under the general Code definitions of those terms. The bill clarifies that the 1986 Act's amendment to the FPHC tracing rules treats estates and trusts as intervening foreign entities if and only if they are foreign estates and foreign trusts under the general Code definitions.

The bill provides that, in making adjustments to the tracing rules by regulation, the Secretary may impose rules similar to the rules of Code section 1297(b)(5) (as amended by the bill) applicable to passive foreign investment companies (PFICs). These rules will provide for similar treatment, under regulations, of distributions from FPHCs, on the one hand, and entities through which FPHC ownership is attributed, on the other. For example, where stock ownership in a FPHC is attributed to a U.S. person through an intervening entity, it is anticipated that regulations will treat distributions received by the intervening entity as being received by the U.S. person. These regulations will prevent reduction of FPHC income by virtue of distributions that result in no U.S. tax.

Same country dividend and interest exception

The bill makes amendments to the 1984 and 1986 Act provisions relating to the same country dividend and interest exception to FPHC income treatment. One such amendment defines a new term, "related person dividend or interest," as a same country dividend or same country interest of the type excluded from FPHC income under the 1984 Act. The bill restores related person dividend and related person interest to the denominator of the fraction used in determining whether a foreign corporation is an FPHC. The bill also restores FPHC income treatment of a related person dividend or interest if the dividend or interest is attributable to income of the related person which would be FPHC income.

Thus, for example, where the entire amount of a foreign corporation's income is related person dividends and related person interest, and in any taxable year some of that income, but less than 60 percent (assuming the corporation has never been an FPHC), is attributable to income of the related persons which would be FPHC income, the bill prevents the foreign corporation from being treated as an FPHC.

Attribution of dividends and interest to income of the related person is to be determined under rules similar to the foreign tax credit look-through provisions for dividends and interest paid to a U.S. shareholder by a controlled foreign corporation. Under these rules, a dividend paid out of the earnings and profits of a corporation is to be treated by the recipient as FPHC income in proportion to the FPHC earnings and profits out of which the dividend was paid, divided by the total earnings and profits out of which the dividend was paid (*cf.* sec. 904(d)(3)(D)). Similarly, interest received or accrued from corporation is to be treated as FPHC income to the extent properly allocable (under regulations prescribed by the Secretary) to FPHC income of the corporation (*cf.* sec. 904(d)(3)(C)).

All of the bill's provisions described above regarding foreign personal holding companies apply to taxable years of foreign corporations beginning after December 31, 1986.

3. Withholding on pensions, annuities and certain other deferred income (sec. 6674(bb)(2) of the bill, sec. 1234(b) of the Reform Act, and sec. 3405 of the Code)

Present Law

The Act provides that pension benefits (and similar payments) are subject to withholding under section 3405 if delivered outside the United States. The election generally available to U.S. persons to forego withholding under section 3405 is not available in such cases. Congress enacted this provision with a view to taxing persons who reside abroad yet are likely to owe U.S income tax on pension benefits (and similar payments) that they receive.

Explanation of Provisions

The bill clarifies that the Act's automatic withholding rules does not apply if the recipient certifies to the payor that he or she is not a U.S. citizen or a resident alien of the United States, and not a tax avoidance expatriate. Thus under the bill the automatic withholding rule generally applies to foreign-delivered pension benefits and similar payments to individuals subject to U.S. income taxation on their worldwide income.

4. Information exchange (sec. 6674(bb)(3) of the bill, sec. 1876(e) of the Reform Act, and sec. 6103 of the Code)

Present Law

Tax returns and return information generally may not be disclosed by government employees except as specifically provided in the Code. Violation of the nondisclosure rules may result in sanctions, including criminal felony conviction in the case of a willful violation. One Code exception to the general nondisclosure rule permits disclosure of a return or return information to a competent authority of a foreign government which has an income tax convention, gift and estate tax convention, or other convention relating to the exchange of tax information with the United States, but only to the extent provided in, and subject to the terms and conditions of, the convention. The Code also permits disclosure of a return or return information to state government agencies under certain circumstances. For these purposes the term "state" is defined to include the Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau.

In 1983, the Caribbean Basin Economic Recovery Act authorized the Secretary of the Treasury to negotiate and conclude bilateral and multilateral agreements for the exchange of information with designated "beneficiary countries" under the Caribbean Basin Initiative (CBI). Congress expected that these agreements would generally become effective on signature, without need of prior approval by the Senate. The Code treats these agreements with CBI beneficiary countries as income tax conventions for return and return information disclosure purposes.

The Compact of Free Association Act of 1985 gave approvals to compacts subsequently entered between the United States and the Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau that provide for their self-government. Congress provided that under those compacts the Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau would be treated as if they were U.S. possessions for purposes of the possessions tax credit (Code sec. 936), but that this treatment would not apply for any period after 1986 in which there is not in effect an exchange of information agreement of the kind described in the Caribbean Basin Economic Recovery Act. The Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau are not CBI beneficiary countries.

The 1986 Act provided that a country may qualify as a host country for foreign sales corporations (FSCs) by entering into an exchange of information agreement of the type provided for in the Caribbean Basin Economic Recovery Act, whether or not that country is eligible to be a CBI beneficiary country.

Explanation of Provision

The bill clarifies that tax returns and return information may be disclosed to a competent authority of a foreign government where the disclosure is made pursuant to a bilateral agreement relating to the exchange of tax information with the United States. Thus, where a country other than a CBI beneficiary country enters into a bilateral information exchange agreement of the type that qualifies it as a FSC host country under the Act, for example, or that qualifies it for the possessions tax credit pursuant to the Compact of Free Association Act, the bill provides express protection to individuals who make disclosures in accordance with the terms of the agreement from Code sanctions for unauthorized disclosures. By contrast, however, the bill does not contemplate the relase of information under multilateral agreements involving non-CBI countries.

In addition, the bill provides that the Federated States of Micronesia, the Republic of the Marshall Islands, and the Republic of Palau are not to be treated as "states" for purposes of the disclosure provisions of the Code. Thus, an authorized disclosure under a bilateral information exchange agreement between the United

States and one of those governments will be subject only to the rules embodied in that agreement and the usual rules for information exchanges with foreign governments, and will not be subject to any additional rules that might apply to exchanges of tax returns and return information between the federal government and state governments or certain U.S. possessions.

5. Maintaining the source of U.S. source income (sec. 6674(bb)(4) of the bill, sec. 1810(a) of the Reform Act, and sec. 904(g) of the Code)

Present Law

Prior to the 1984 Act, a U.S. taxpayer could convert U.S. source income to foreign source income by routing the income through a foreign corporaton: interest and dividend payments from (and income inclusions with respect to) an intermediate foreign corporation generally were foreign source income to the U.S. taxpayer. As foreign source income, the income could be free of U.S. tax under the foreign tax credit.

The 1984 Act added to the foreign tax credit new "resourcing" rules that prevent U.S. taxpayers from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. They treat certain payments from, and income inclusions (*e.g.*, under the subpart F anti-tax haven provisions) arising on account of, 50-percent U.S.-owned foreign corporations, as U.S. source.

The 1986 Act made it clear that the source maintenance rules apply notwithstanding any contrary U.S. treaty obligation.

Explanation of Provision

The bill provides new treatment for any amount derived from a 50-percent U.S.-owned foreign corporation that the statute would treat as U.S. source income (because it is attributable to an item of U.S. source income earned by that foreign corporation), that a treaty (applied without regard to the statutory source maintenance provision) would treat as foreign source, and with respect to which the taxpayer chooses the new treatment. Upon such a taxpayer election, to the extent attributable to an item of U.S. source income earned by that foreign corporation, the taxpayer's inclusion is treated as foreign source income that is subject to a separate foreign tax credit limitation. The bill extends this elective treatment to subpart F inclusions (Code section 951(a)((1)) by treating any such inclusion as if it were a dividend from the controlled foreign corporation causing the inclusion but only if a dividend from each intermediary corporation in the layers of ownership between the corporation generating the subpart F inclusion and the U.S. shareholder would be treaty protected if paid to the U.S. shareholder. It is anticipated, however, that for administrative convenience the Secretary may allow grouping of similar items that are similarly taxed by a foreign country in applying the separate foreign tax credit limitation.

6. Stock sales treated as asset sales (sec. 338(h)(10) of the Code and sec. 6674(bb)(5) of the bill)

Present Law

Section 338 generally and 338(h)(10) in particular allow in certain circumstances a sale of stock in an affiliated corporation to be treated as a sale of the affiliated corporation's assets. A sale of stock in a U.S. corporation is sourced under the residence-of-the-seller rule while a sale of assets is sourced under the residence-of-the-seller rule, the place-of-sale rule, the rules relating to intangible property, or the recapture rule depending on the type of asset sold and the income generated therefrom. Thus, for example, if an election under section 338(h)(10) is made, the income inherent in the appreciation of the stock may or may not be sourced under the residence-of-the-seller rule. This may result in income being treated as foreign source even though no foreign country asserts any jurisdiction over the income, a result contrary to the Act's source and foreign tax credit rule changes.

Explanation of Provision

The bill provides, except as provided in regulations, that an election under section 338(h)(10) to treat a sale of stock in an affiliated corporation as a sale of assets does not treat that sale as a sale of assets for purposes of determining source in determining the seller's foreign tax credit limitation. Instead, for these purposes, the gain is treated as a gain from the sale of the stock. An exception to this rule is provided for gain derived from the deemed sale of stock in a controlled foreign corporation to the extent that the gain is treated as dividend income under section 1248. To that extent, income derived from the sale of stock of the U.S. corporation is treated, for foreign tax credit purposes, as income from the sale of the corporation's assets.

It is anticipated that any regulations prescribed under the general regulatory authority provided under section 338 will limit the applicability of the scope of section 338 so that that section will not affect inappropriately the determination of source and of a taxpayer's foreign tax credit limitation. Moreover, to the extent that regulations prescribed under section 336(e) extend the principles of section 338 to a sale of stock in a foreign corporation, it is anticipated that those regulations will not affect inappropriately the determination of source and of a taxpayer's foreign tax credit limitation. For example, the committee does not believe it is appropriate to allow the conversion of foreign source passive income into overall limitation income on the sale of stock of a controlled foreign corporation by means of an election under section 338. The committee intends that regulations ensure that the objectives of the Act's foreign tax credit limitation changes are preserved.

The bill's modification to section 338(h)(10) is effective for transactions occurring after the date of the bill's introduction.

7. Treatment of certain amounts previously taxed under section 1248 (sec. 6674(bb)(6) of the bill and sec. 959 of the Code)

Present Law

A U.S. shareholder that sells stock in a controlled foreign corporation must include in income as a dividend its share of the corporation's earnings and profits accumulated since the corporation was controlled and that are attributable to the stock sold (sec. 1248). Except as provided as regulations, a sale of stock in a U.S. corporation that is formed principally to hold the stock of a controlled foreign corporation is treated as a sale of the stock in the controlled foreign corporation (sec. 1248(e)), thus requiring the seller to recognize dividend income rather than capital gain.

Under the Tax Reform Act of 1984, a U.S. shareholder that purchases stock from a U.S. shareholder in a controlled foeign corporation is allowed to treat distributions received from the corporation as previously taxed income to the extent of the dividend income recognized by the seller (sec. 959(e)). Under this rule, a U.S. shareholder that purchases stock in a U.S. corporation that is formed principally to hold the stock of a controlled foreign corporation is entitled to the previously taxed income treatment, even though the U.S. corporation whose stock is sold is the actual shareholder in the controlled foreign corporation.

Explanation of Provision

The bill provides that a purchaser of stock in a U.S. corporation that is formed principally to hold the stock of a controlled foreign corporation will not receive previously taxed income treatment, but that treatment will be accorded to the U.S. corporation whose stock was acquired where dividend treatment applies to the seller of stock in the U.S. corporation under 1248(e). Thus, the U.S. corporation can receive distributions from the controlled foreign corporation and treat them as previously taxed income to the extent of the dividend income recognized by the seller of stock in the U.S. corporation.

The bill's amendment is effective for transactions to which section 1248(e) applies and that occur after December 31, 1986.

8. Shared FSC (secs. 922, 924, and 927 of the Code and sec. 6674(bb)(7) of the bill)

Present Law

A foreign sales corporation (FSC) may have up to 25 shareholders, but may not have any perferred stock.

Explanation of Provision

In general, each separate account maintained by a shared FSC is treated as a separate corporation for income tax purposes. A shared FSC is any foreign sales corporation that maintains a separate account for transactions with each shareholder (and persons related to such shareholder) that bases its distributions to each shareholder on the amounts in the separate account maintained with respect to each shareholder, and meets such other requirements as the Secretary may prescribe. The treatment of each separate account of a shared FSC as a separate corporation does not apply, however, for certain corporate-level requirements for FSC status, for the foreign presence and foreign economic process requirements, for the determination whether a FSC is a small FSC, and for such other purposes as the Secretary may prescribe. This provision is effective as if included in the Deficit Reduction Act of 1984.

XIII. Tax-Exempt Bond Provisions (Sec. 6675 of the bill, Secs. 1301, 1302, and 1311-1318 of the Reform Act, and Secs. 25, 103, and 141-150 of the Code)

1. Qualifed small-issue bonds

Present Law

Allowance of post-sunset date refundings

Qualified small-issue bonds may be issued to finance manufacturing facilities through December 31, 1989. Authority to issue qualified small-issue bonds for nonmanufacturing facilities expired after December 31, 1986.

The Reform Act allows qualified small-issue bonds issued after August 15, 1986, to be refunded after the applicable sunset date of authority to issue the type of bond involved, if—

(a) the refunding bond has a maturity date not later than that of the refunded bond;

(b) the amount of the refunding bond does not exceed the outstanding amount of the refunded bond;

(c) the interest rate on the refunding bond is lower than the interest rate on the refunded bond; and

(d) the net proceeds of the refunding bond are used to redeem the refunded bond not later than 90 days after the date of issuance of the refunding bond.

No comparable provision was contained in the 1954 Code which governs such refundings of bonds originally issued before August 16, 1986. (*See,* Reform Act sec. 1313(a).)

$40-million-per-beneficiary limit

Interest on small-issue bonds is not tax-exempt if the aggregate face amount of exempt-facility and qualified smnall-issue bonds (including equivalent prior-law IDBs) allocated to any beneficiary of the small-issue bonds exceeds $40 million. An exception to this rule is provided for certain current refundings of qualified small-issue bonds, under the same conditions as apply to post-sunset date refundings of such bonds (as described above).[1]

Explanation of Provisions

Allowance of post-sunset date refundings

The bill clarifies that post-sunset date current refundings (including a series of such refundings) of qualified small-issue bonds (including small-issue IDBs), which bonds are originally issued before the applicable sunset date for the type of small-issue bond involved, qualify for tax-exemption, without regard to whether the refunded (original) bonds were issued before August 16, 1986, and without regard to the requirement included in the Reform Act that the interest rate on the refunding bonds be lower than the rate on refunded bonds. Such refundings on bonds originally issued after August 15, 1986, are permitted under sec. 144(a)(12) of the 1986 Code, as modified by the bill. Refundings of bonds originally issued before August 16, 1986, are permitted under a parallel rule which is added by the bill to the 1954 Code. Under this latter rule, bonds may qualify to be refunded if they could have been originally issued on August 15, 1986 (e.g., the "substantially all" (90 percent) requirement of the 1954 Code applies rather than the new 95 percent use requirement).

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[1] In the case of refundings of bonds originally issued before August 16, 1986, the 90-day limit on completing a refunding is reduced to 30 days. *See,* Title XVIII of the Reform Act.

Post-sunset date refundings of qualified small-issue bonds are permitted under the bill provided that—

(a) the average maturity date of the issue of whch the refunding bond is a part does not exceed the average maturity date of the bonds being refunded by such issue,[2]

(b) the amount of the refunding bond does not exceed the outstanding amount of the refunded bond, and

(c) the net proceeds of the refunding bond are used to redeem the refunded bond not later than 90 days after the date of issuance of the refunding bond.[3]

As indicated above, the bill replaces the limitation on the maturity of each refunding bond, contained in the Reform Act, with a limitation on the average maturity of the refunding issue (as compared to the average maturity of the refunded bonds). However, the bill provides that any refunding bond issued before July 1, 1987, which complied with the requirement as contained in the Reform Act, is treated as satisfying the new requirement.

The bill also extends the 1954 Code sunset date for small-issue IDBs for manufacturing facilities, from December 31, 1988, to December 31, 1989. This change permits bonds for manufacturing facilities which were issued before August 16, 1986 to be refunded through December 31, 1989, without regard to the special limitations (described above) that apply to post-sunset date refundings.

$40-million-per-beneficiary limit

In conjunction with the amendments described above, the bill makes conforming changes to the refunding exception from the $40-million-per-beneficiary limit on qualified small-issue bonds. Thus, for purposes of this exception also, the weighted average maturity of the refunding bonds is compared to that of the refunded bonds, and the requirement that the refunding bonds have a lower interest rate than the rate on the refunded bonds is deleted. The bill further clarifies that a series of refundings may qualify under this exception. As under the rules for post-sunset date refundings, refunding bonds issued before July 1, 1987, which complied with the maturity requirement as contained in the Act, are treated as meeting the new requirement.

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[2] Average maturities, for this purpose, are determined in the same manner as for purposes of the limitation on private activity bond maturity to 120 percent of the economic life of the property being financed.

[3] The bill increases this period from 30 days to 90 days for refunding of bonds originally issued under the 1954 Code to conform the rules for all post-sunset date refundings of small-issue bonds.

2. Student loan bonds

Present Law

Tax-exemption is authorized for interest on qualified student loan bonds, including bonds issued in connection with the Federal GSL and PLUS programs and certain State supplemental student loan programs. Bonds issued in connection with the Federal GSL and PLUS programs must be used to finance loans that are both (1) guaranteed by the Department of Education and (2) eligible for student assistance (SAP) payments (unless such payments are precluded solely by virtue of the tax-exempt status of the bonds). Additionally, the interest charged to student borrowers must be restricted as provided in the Higher Education Act of 1965. Bonds that meet some, but not all, of these requirements (e.g., bonds the proceeds of which are used to make student loans that receive Federal guarantees, but for which SAP payments are not available) may in certain cases not meet the definition of State supplemental student loan bonds and therefore may not qualify for tax exemption.

Explanation of Provisions

The bill clarifies that student loan bonds that fail to satisfy some but not all of the requirements of Title IV of the Higher Education Act of 1985 may be issued under the exception for State supplemental student loans bonds, provided that the bonds otherwise satisfy all requirements applicable to tax-exempt supplemental student loan bonds.

The bill clarifies that an issue may not qualify as an issue of qualified student loan bonds if the issue satisfies the trade or business use and security interest tests contained in the Reform Act (Code secs. 141(b)(1) and (2)). For purposes of this provision, "use" by a section 501(c)(3) educational institution solely by reason of its administration of a student loan program does not affect the tax-exempt status of an issue, provided such use does not constitute an unrelated trade or business of the institution.

3. Qualified 501(c)(3) bonds

Present Law

Present law permits tax-exemption for interest on bonds to benefit section 501(c)(3) organizations (qualified 501(c)(3) bonds). The Reform Act provides that no more than $150 million of such bonds (other than hospital bonds) may be outstanding with respect to any section 501(c)(3) organization at any time. The tax-exempt status of bonds issued before August 16, 1986, is not affected by the provision; however, such bonds count in applying the provision to bonds issued after August 15, 1986.

In the case of pre-August 16, 1986 bonds, only the nonhospital portion of a mixed-use bond counts toward the $150-million limitation. Whether such allocations are permitted for mixed-hospital/

nonhospital-use bonds issued after August 15, 1986, is not specified in the Reform Act.

Explanation of Provisions

The bill clarifies that the proportional allocation rule included in the $150-million-per-beneficiary limit for qualified 501(c)(3) bonds, for mixed-hospital/nonhospital-use issues, applies to bonds issued after August 15, 1986, as well as to bonds issued before August 16, 1986.

The bill also adds a statutory reference clarifying that related party rules, similar to those applied for purposes of the $40-million-per-beneficiary limitation on qualified small-issue bonds, are to apply under the $150-million limitation.

4. Mortgage revenue bonds and mortgage credit certificates

Present Law

Under present law, authority to issue qualified mortgage bonds terminates after December 31, 1988. Before enactment of the Reform Act, this termination date was December 31, 1987. These bonds may not be refunded after expiration of authority to issue them.

Current refundings (including a series of refundings) of qualified mortgage bonds originally issued before August 16, 1986, remain subject to the 1954 Code. (*See,* Reform Act sec. 1313(a).) Thus, bonds originally issued before August 16, 1986, may not be refunded after December 31, 1987.

The Reform Act generally amends the provisions governing issuance of mortgage credit certificates (MCCs) to parallel the qualified mortgage bond provisions. However, the Reform Act incorrectly retained the 1987 termination date for the MCC program, rather than extending it to parallel the 1988 termination of authority to issue qualified mortgage bonds.

Explanation of Provisions

The bill extends the 1954 Code sunset date for qualified mortgage bonds from December 31, 1987, to December 31, 1988, to parallel the 1988 sunset contained in the 1986 Code. This permits qualified mortgage bonds issued before August 16, 1986, to be refunded through December 31, 1988. As was stated in the legislative history accompanying the Act for refundings occurring before January 1, 1988, refundings permitted under this expansion of the transitional exception are subject to certain restrictions related to the period for originating loans to homebuyers. *See,* 14., below.

Authority to elect to issue mortgage credit certificates is extended through December 31, 1988, to parallel the qualified mortgage bond expiration date.

5. Private activity bond volume limitation

Present Law

Subject to certain exceptions, State volume limitations are imposed on the issuance of (a) private activity bonds and (b) the private use portion (in excess of $15 million) of governmental issues. Bond volume authority generally may be allocated only to facilities located within the State making the allocation. Under a limited exception, volume authority may be allocated to private activity bonds for out-of-State water-furnishing, sewage and solid waste disposal, and qualified hazardous waste disposal facilities, if the issuer establishes that the State's share of the use (or output) of the facility will equal or exceed its share of the private activity bonds issued to finance the facility.

State volume authority may be carried forward for up to three years for certain specified purposes.

Current refunding bonds are not subject to the State volume limitations if certain requirements are satisfied. In the case of qualified mortgage bonds and student loan bonds, the legislative history accompanying the Reform Act states that the refunding bonds are exempt from volume limitations only if the period for originating loans does not exceed three years from the date the refunded (original bonds in the case of a series of refundings) were issued.

Explanation of Provision

The bill expands the circumstances in which State volume authority may be allocated to certain out-of-State facilities to permit such allocations for out-of-State facilities financed with governmental bonds, the private use portion of which exceeds $15 million, if the governmental facilities (a) are equivalent to any of the categories for which out-of-State allocations are permitted in the case of private activity bonds (i.e., water-furnishing facilities, sewage and solid waste facilities, and qualified hazardous waste disposal facilities), or (b) are governmental output facilities financed with tax-exempt bonds.[4]

Allocations with respect to governmental bonds are permitted only if the State's share of the use (or output) of the private use portion of the bond-financed facility equals or exceeds the State's share of volume authority allocated to the facility. The committee wishes to clarify that, unlike the general rule that bond volume authority may not be allocated to an issuer that is not within or subordinate to the same State as the issuer, these allocations may, in certain cases, be made to another State. For example, assume that a governmental power generation facility is located in Nevada, but is owned by a California municipality. Assume further that the California municipality issued bonds to be advance refunded, but that the private use portion of those bonds is attributable to use by an investor-owned utility in Nevada. In such a case, Nevada may allocate its bond volume authority to the California municipality's advance refunding issue in an amount sufficient to cover the Nevada private use of the refunded (and thereby refunding) bonds.

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[4] Because of the limitation to $15 million per facility for private use financing for these output facilities, this provision will only apply to refundings of such bonds originally issued before September 1, 1986.

6. Public approval requirement for private activity bonds

Present Law

In order for interest on a private activity bond to be tax-exempt, a public hearing must be held and issuance of the bonds approved by an elected public official or legislative body. (Alternatively, issuance of the bonds may be approved by a voter referendum.) Subject to certain exceptions, this requirement must be satisfied by the governmental unit issuing the bonds (or on behalf of which the bonds are issued) and all other jurisdictions in which the bond-financed property (or any part of it) is located.

Explanation of Provision

The bill clarifies that, in the case of qualified scholarship funding bonds, the public approval requirement for private activity bonds is to be satisfied by a governmental unit which requested organization of the qualified scholarship funding corporation, or requested it to exercise power. (*See*, sec. 150(d)(2)(B).)

7. Limitation on bond-financing of issuance costs

Present Law

At least 95 percent of the proceeds of each issue of private activity bonds must be used for the exempt purpose of the issue. Amounts used to finance any costs of issuance are not treated as spent for the exempt purpose of the borrowing. Thus, these costs may be financed only from the so-called 5-percent "bad money" portion of an issue. Additionally, the amount of private activity bond proceeds that may be used to finance costs of issuance (other than such costs attributable to financing of credit enhancement fees eligible for special treatment under the arbitrage restrictions) is limited to two percent of the aggregate face amount of the issue. (For mortgage revenue bond issues not exceeding $20 million, this 2-percent limit is increased to 3.5 percent.)

Explanation of Provision

The bill clarifies that the 2-percent (3.5-percent) limitation on bond-financing of certain private activity bond issuance costs is applied to the proceeds, rather than the aggregate face amount, of an issue. Thus, no more than 2 percent (3.5 percent) of the proceeds of a private activity bond issue may be used to finance most issuance-related costs.

This provision is effective for bonds issued after June 30, 1987.

8. Arbitrage requirements

Present Law

General restrictions

The Reform Act continued and expanded general restrictions on the ability to invest bond proceeds at yields materially higher than the yield on the issue. In addition, the Act expanded the types of investments subject to the arbitrage restrictions from securities generally to all investment-type property.[5]

The Treasury Department is authorized specifically to adopt all regulations that are "necessary or appropriate to carry out the purposes" of the Code arbitrage restrictions (sec. 148(i)). Similar broad regulatory authority was granted under the 1954 Code (sec. 103(c)(7)). Treasury Department regulations and rulings issued pursuant to this regulatory authority define the term proceeds for purposes of both prior and present law and provide that certain amounts are to be treated as proceeds. These regulations restrict, *inter alia,* transactions involving sinking funds where bond proceeds are used to "replace" the amounts invested (either before or after issuance of the bonds) as part of the sinking fund. Similar treatment applies to funds that are pledged to pay debt service on an issue and, thus, are "replaced" by process of the issue. *See,* e.g., Treas. reg. sec. 1.103-13(g).

In a recent case, *City of Tucson* v. *Commissioner,* 820 F. 2d 1283 (D.C. Cir., 1987), the Court of Appeals for the D.C. Circuit held Treas. Reg. sec. 1.103-13(g) to be invalid. The court further cast doubt on other provisions of Treasury regulations and the holdings of several revenue rulings issued by the Internal Revenue Service regarding replacement funds and artifices and devices. (*See,* e.g., footnotes 49, 50, 51, 52, and 54 of the court's opinion.) This case was decided under the 1954 Code, but the court indicated that the regulations also might be invalid under the 1986 Code. (On September 24, 1987, the court denied a Treasury Department petition to dismiss the case as moot because of enactment of the 1986 Code.)

General requirement to rebate arbitrage profits

Issuers of all tax-exempt bonds are required to rebate certain arbitrage profits earned on nonpurpose investments acquired with gross proceeds of the bonds. The amount required to be rebated is determined, and paid, on an issue-by-issue basis. Ninety percent of the rebate required with respect to any issue must be paid at least once each five years, with the balance being due no later than 60 days after retirement of the issue.

Rebate safe-harbor for certain TRAN financings

Arbitrage profits are not required to be rebated with respect to an issue if all gross proceeds are expended for the governmental purpose of the issue within 6 months of the issue date. The Reform Act provides a special "safe harbor" for applying this exception to tax and revenue anticipation notes (TRANs). Under this safe harbor, if, during the six-month period after the issue date, the cumulative cash-flow deficit of the governmental unit using the TRAN proceeds exceeds 90 percent of the aggregate face amount of the issue, all net proceeds of the TRAN issue (and any earnings thereon) are deemed to have been spent for the purpose of the issue.

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[5] In general, property is investment-type property in any case where it is held as a passive vehicle for the production of income. Thus, ownership of the physical assets of a commercial or industrial facility may, due to the purpose for which the facility is held, be investment-type property subject to yield restriction in the same manner as ownership of securities.

Special exception from rebate for small governmental units

The Reform Act provides a further exception to the rebate requirement for bonds issued by a governmental unit having general taxing powers, if (a) 95 percent or more of the net proceeds of the issue are to be used for local governmental activities of the issuing governmental unit (or a governmental unit entirely within the jurisdiction of the issuing governmental unit), and (b) the governmental unit reasonably expects to issue no more than $5 million of tax-exempt bonds during the calendar year in which the issuance occurs. In determining whether an issuer reasonably expects to exceed the $5 million limitation, bonds issued by the issuing governmental unit and all entities that are subordinate to it under applicable State or local law are counted. Private activity bonds are not counted toward the limit and do not qualify for this exception.

For bonds issued and refunded during the same calendar year, only the proceeds of the refunding issue are taken into account for purposes of the $5 million dollar limit. This provision does not apply to advance refundings.

The Reform Act is unclear as to the eligibility for this exception of bonds issued by subordinate units to governmental units with general taxing powers.

Exception for certain qualified student loan bonds

The Reform Act provides a limited transitional exception to the rebate requirement for qualified student loan bonds issued before January 1, 1989, in connection with the Federal GSL and PLUS programs. Under this exception, the rebate requirement does not apply to amounts earned from investing bond proceeds during an initial 18-month temporary period if—

(a) the earnings are used to pay costs of issuance financed with the bonds; or

(b) the earnings are used to pay administrative costs of the student loan program attributable to the issue and the costs of carrying the issue, but only to the extent that the proceeds of the issue are used to make or finance qualified student loans before the end of the 18-month temporary period.

This exception applies only to the extent issuers are not otherwise reimbursed for these costs.

Explanation of Provisions

General restrictions

The bill enacts into positive law the provisions of Treasury regulation sec. 1.103-13(g) regarding sinking funds. Under this provision, these regulations are to apply to all bond issues, under both the 1954 Code and the 1986 Code, in the same matter as originally provided when Treasury adopted the regulations. The committee has taken this unusual step to eliminate any ambiguity caused by the Court of Appeals incorrect decision in the *City of Tucson* case.

The bill further deletes and re-inserts the term "necessary" in the specific regulatory authority granted the Treasury Department under the arbitrage restrictions. This amendment is intended to clarify that Treasury's regulatory authority is to be interpreted broadly, rather than in a literal, dictionary manner as was done by the Court of Appeals in the *City of Tucson* case. That regulatory authority is intended to permit Treasury to eliminate any devices designed promote issuance of bonds either partially or wholly as investment conduits in violation of the provisions adopted by Congress to control such activities and to limit the issuance of tax-exempt bonds to amounts actually required to fund the activities for which their use specifically has been approved by Congress. Further, that regulatory authority is intended to permit Treasury to adopt rules (including allocation, accounting, and replacement rules) necessary or appropriate to accomplish the purpose of the arbitrage restrictions, which is to eliminate significant abritrage incenties to issue more bonds, to issue bonds earlier, and to leave bonds outstanding longer.

Due date of final rebate payments

The bill provides a special rule for determining the due date of the final installment of rebate payments in the case of certain short-term governmental financings. Under this rule, a series of issues that are redeemed during a 6-month period (or such longer period as the Treasury Department may prescribe) are to be treated, at the election of the issuer, as one issue, provided that no bond which is part of any issue in the series (a) has a maturity of more than 270 days (or such longer period as the Treasury may prescribe) or (b) is a private activity bond. Each 6-month period begins on the date on which the first obligation of the series is issued, or if later, September 1, 1986.

Exception for certain TRAN financings

The bill clarifies that the expenditures determination for the "safe harbor" exception to the rebate requirement for certain tax or revenue anticipation notes (TRANs), is determined by reference to the proceeds, rather than the aggregate face amount, of an issue. Thus, under the clarification, net proceeds of an issue are treated as expended for the governmental purpose of the issue on the first day (after the date of issuance) on which the cumulative cash flow deficit to be financed by the issue exceeds 90 percent of the issue proceeds.

This provision is effective for bonds issued after June 30, 1987.

Exception for small governmental units

Aggregation of entities

Under the Reform Act, bonds of a governmental unit with general taxing powers may qualify for the special exception from arbitrage rebate only if the governmental unit and all subordinate entities reasonably expect to issue no more than $5 million of tax-exempt bonds (other than private activity bonds) during the calendar year. The bill clarifies the reference to subordinate entities contained in the Reform Act to provide that issuers are to be aggregated, for purposes of applying the $5-million limitation, as follows:

(a) An issuer, and all entities which issue bonds on behalf of that issuer, are to be treated as one issuer.

(b) If one issuer is subordinate to another entity, but does not issue bonds on behalf of the other entity, bonds issued by the subordinate entity are to be taken into account in applying the $5-million limitation to such other entity.

(c) Any entity that is formed or, as provided in Treasury regulations, availed of to avoid the purposes of the $5-million limitation, and all other entities purporting to benefit from such a device are treated as one issuer.

Treatment of refundings

The bill clarifies that current refunding bonds are not considered in determining whether an issuer otherwise qualifies for the small-issuer rebate exception provided the amount of the refunding issue does not exceed the outstanding (redeemed) principal amount of the refunded bond. Advance refunding bonds are considered in determining whether an issuer reasonably expects to issue $5 million or more in bonds in the same manner as new money bonds.

Refunding bonds (both current and advance) are themselves eligible for this exception from rebate only if (a) the refunded bond qualified for, and was taken into account under, the $5 million exception when issued,[6] (b) the aggregate face amount of the issue of which the refunding bond is a part does not exceed $5 million, (c) except in the case of refunded issues having a weighted average maturity of 3 years or less, the weighted average maturity of the refunding bonds does not exceed the weighted average maturity of the refunded bonds, and (d) no bond which is part of the refunding issue has a maturity in excess of 30 years (measured from the date of issuance of the original bonds).

Bonds issued by certain entities subordinate to governmental units with general taxing powers

The bill clarifies that governmental units with general taxing powers may, in certain cases, allocate to a subordinat entity part or all of the $5 million amount of governmental bonds they may issue in a calendar year. To qualify, the subordinate entity may not issue bonds in excess of the amount that could be issued if the allocating entity had directly issued the bonds. Additionally, the allocation must bear a reasonable relationship to the benefits received by the allocating governmental unit with general taxing powers. (Amounts allocated to subordinate entities, of course, reduce the aggegate amount of bonds that the entity making the allocation may issue directly, or through other subordinate entities, while remaining qualified for the small-issuer rebate exception.)

The committee intends that all allocations must be made in advance of issuance of the bonds, and that once made, the allocations are irrevocable. The committee further intends, that in the case of entities subordinate to more than one allocating governmental unit with general taxing powers, only the proportionate part of the bonds represented by the benefit received by each allocating governmental unit be treated as issued by that unit provided allocations satisfying the criteria above are made in advance of issuance. Absent qualifying allocations, the entire amount of the bonds issued by such multi-jurisdictional issuers will be treated as issued by each governmental unit to which the issuer is subordinate.

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[6] Bonds issued before September 1, 1986, that would have qualified for the exception when issued had the new arbitrage restrictions applied to the issue of which they were a part are treated as satisfying this requirement.

Effective date

The amendments to the small governmental unit rebate exception apply generally to bonds issued after June 30, 1987. A special rule is provided permitting governmental units qualifying for the exception to elect to treat the amendments as if inlcuded in the Tax Reform Act of 1986 (i.e., as applying to bonds issued after August 31, 1986).

Exception for certain qualified student loan bonds

The Reform Act provides a transitional exception from the rebate requirement for temporary period earnings of certain qualified student loan bonds, which earnings are used to pay otherwise unreimbursed costs. The bill clarifies that (a) amounts paid by student loan borrowers as interest are not to be taken into account in determining whether an issuer is reimbursed for costs under this provision, and (b) in the case of bonds eligible for this rebate exeption, except as provided otherwise in future Treasury regulations, amounts earned under the exception also may be taken into account in determining yield on the student loans (i.e., interest payments by student borrowers at rates generally established by the U.S. Department of Education for GSL and PLUS bonds, will not be treated as reimbursed under present Treasury regulations).

9. Prohobition of Federal guarantees

Present Law

Interest on Federally guaranteed bonds does not qualify for tax-exemption. An exception is provided (*inter alia*) for any guarantee by the Bonneville Power Authority pursuant to the Northwest Power Act (16 U.S.C. sec. 839d), as such provision was in effect on July 18, 1984, if the bonds are issued before July 1, 1989.

The District of Columbia generally is not treated as a U.S. instrumentality for purposes of the Federal guarantee prohibition, and accordingly is permitted to issue tax-exempt obligations. The District is however treated as a U.S. instrumentality in the case of certain private activity bonds. Under the Act, these include exempt-facility, qualified small-issue, student loan, and qualified redevelopment bonds, if such bonds are secured other than as revenue bonds.

Explanation of Provision

The bill clarifies that the exception to the Federal guarantee prohibition for any guarantee by the Bonneville Power Authority pursuant to the Northwest Power Act (16 U.S.C. sec. 839d), as such act was in effect on July 18, 1984 (i.e., the date of enactment of the Tax Reform Act of 1984), is a permanent provision.

The bill further clarifies that issuance of qualified redevelopment bonds, by the District of Columbia is not precluded by the prohibition on Federal guarantee of tax-exempt bonds solely by virtue of a pledge of tax security as required for such bonds under the Code.

10. Change in use rules

Present Law

Under the Reform Act, deductions for interest and certain other charges are denied if property financed with private activity bonds is used in a manner not qualifying for tax-exempt financing with the type of bond involved at any time before the bonds are redeemed. Interest deductions may again be claimed once use of the property reverts to a use qualifying for tax-exempt financing.[7]

The legislative history accompanying the Reform Act provides that the change in use penalties apply to property financed with small-issued bonds as well as to other private activity bonds. Additionally, that legislative history states that a change in use resulting in loss of interest deductions occurs in the case of small-issue bonds if the special $10 million capital expenditure limit applicable to those bonds is violated.

Explanation of Provision

The bill clarifies that users of qualified small-issue bond proceeds, like users of the proceeds of other private activity bonds, are subject to the new change in use penalties. The bill codifies the rule that a change in use of facilities financed with qualified small-issue bonds is deemed to occur if post-issuance capital expenditures result in the $10-million small-issue size limitation being violated as well as when bond-financed facilities are used in a manner specifically prohibited by the Code.

The bill further clarifies that denial of interest deductions on residences financed with mortgage revenue bonds ceases if the housing is again used as a principal residence of the mortgagor.

Multifamily residential rental property bonds.—The bill clarifies that a prohibited change in use of property financed with multifamily residential rental property bonds issued before August 16, 1986, does not occur when the bonds are refunded after August 15, 1986, solely because the property continues to meet the prior-law low-income set-aside requirement (as opposed to the revised set-aside rules of the Reform Act).

11. Bonds issued by certain volunteer fire departments

Present Law

Certain volunteer fire departments are qualified to issue tax-exempt bonds for specified purposes, notwithstanding that the fire departments may not be governmental units (or acting on behalf on such units) within the meaning of the Code. The Reform Act does not specify whether these bonds are private activity bonds.

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[7] The Reform Act is unclear as to the applicability of this rule to housing financed with mortgage revenue bonds.

Explanation of Provision

The bill clarifies that bonds issued by certain volunteer fire departments (sec. 150(e)) are treated as private activity bonds only for purposes of the public approval requirement and the prohibition on advance refunding of private activity bonds. (These bonds are treated as governmental bonds for all other Code purposes.)

This extension to these bonds of the public approval requirement and the prohibition on advance refundings is effective for bonds issued after June 30, 1987.

12. Bonds issued under certain State programs

Present Law

The Reform Act authorizes tax-exemption for interest on bonds issued as part of the Texas Veterans's Land Bond Program, the Oregon Small Scale Energy Conservation and Renewable Resource Loan programs, and the Iowa Industrial New Jobs Training Program. The Reform Act permits annual bond volume authority to be carried forward for most purposes for which private activity bonds may be issued. Carryforwards of annual bond volume authority are not addressed for bonds issued pursuant to these four programs.

Explanation of Provision

The bill clarifies that bonds issued under the Texas Veterans' Land Bond Program, the Oregon Small Scale Energy Conservation and Renewable Resource Loan programs, and the Iowa Industrial New Jobs Training Program qualify for carryforward elections under the applicable private activity bond volume limitations, beginning with elections for the calendar year 1987 volume limitations. Further, the bill clarifies that bonds issued under the Iowa program are treated as satisfying the limitation on bond maturity to 120 percent of the economic life of the assets financed, if the weighted average maturity of the issue does not exceed 20 years.

13. Issuance of tax-exempt bonds by U.S. possessions

Present Law

Both prior law and the Reform Act permitted U.S. possessions to issue tax-exempt bonds where applicable organic Acts in conjunction with other provisions of U.S. law permitted such issuance. The Reform Act deletes, as deadwood, the term "Territory" from the list of qualified issuers of tax-exempt bonds since the only Territories of the U.S. in recent history are now the States of Alaska and Hawaii. Bonds issued by U.S. possessions are subject to all Code requirements that would apply if the bonds were issued by or on behalf of [8] States or local governments.

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[8] See, Treas. reg. sec. 1.103-1(b); Rev. Rul. 63-20, 1963-1 C.B. 24; and Rev. Proc. 82-26, 1982-1 C.B. 476.

Explanation of Provision

The committee wishes to emphasize that the deletion of the word "Territory" from the list of qualified issuers of tax-exempt bonds had no effect on the ability of U.S. possessions (Puerto Rico, the Virgin Islands, American Samoa, and Guam) to issue tax-exempt bonds since those entities continue to be U.S. possessions for this purpose and are not Territories.

14. Effective dates

Present Law

Mortgage credit certificate (MCC) targeting rules

The amendments to the mortgage credit certificate (MCC) targeting rules made by the Act apply to MCCs issued to qualifying homebuyers after August 15, 1986.

Rebate requirement for qualified veterans' mortgage bonds

Under the Act, the extension of the rebate requirement to all tax-exempt bonds generally applies for bonds issued after August 31, 1986 (in the case of certain bonds that were governmental bonds under prior law) or December 31, 1985 (in the case of most other bonds). A special effective date applies in the case of bonds used to fund certain pools. There is no general transitional exception to this requirement.

Prohibition of advance refunding of pension arbitrage bonds and bonds violating investment-type property restriction

The Act expands the arbitrage yield restrictions to apply to, *inter alia,* investments in annuity-type contracts (e.g., pension arbitrage bonds) and all other investment-type property. The restriction on annuity contract investments applies to bonds (including refunding bonds) issued after September 25, 1985. Otherwise, the expansion of the arbitrage restrictions of "all investment-type property" applies to bonds (including refunding bonds) issued after August 15, 1986 (August 31, 1986, in the case of certain governmental bonds, defined as under prior law).

Prohibition of abusive devices in connection with advance refundings

The Act prohibits the use of any device intended to produce arbitrage profits in connection with an advance refunding, effective with respect to bonds issued after December 31, 1986. No inference was intended that such devices were permitted before enactment of the Act.

Repeal of qualified mortgage bond policy statement requirement

Under prior law, issuers of qualified mortgage bonds and MCCs were required to submit to the Treasury Department annual statements explaining their policies in distributing bonds and credits. The Act repealed this requirement.

Explanation of Provisions

Mortgage credit certificate (MCC) targeting rules

The bill clarifies that the amendments to the MCC targeting rules are effective with respect to elections to trade-in qualified mortgage bond authority for authority to issue MCCs, which elections are made after August 15, 1986. This, credits for which elections to trade-in bond authority had been made before August 16, 1986, but which are actually distributed after that date, continue to be subject to the prior-law targeting rules.

Rebate requirement for qualified veterans' mortgage bonds

The bill clarifies that the arbitrage rebate requirement applies to current refundings of qualified veterans' mortgage bonds issued before August 15, 1986, if such refunding bonds are issued after June 30, 1987.

Prohibition of advance refunding of pension arbitrage bonds and bonds violating investment-type property restriction

The bill clarifies that the arbitrage restriction on investment in annuity contracts prohibits advance refundings (as well as new issues) of so-called "pension bonds" after June 10, 1987. Advance refunding of such bonds issued under project-specific transitional exceptions also is prohibited.

The bill further clarifies that the provision expanding the arbitrage restrictions to all "investment-type property" applies to advance refunding bonds issued after October 16, 1987, as well as to new issues.

Prohibition of abusive devices in connection with advance refundings

The bill clarifies that the Reform Act's prohibition on abusive devices in connection with advance refundings applies to bonds issued after August 31, 1986. As provided in the legislative history accompanying the Reform Act, no inference is intended that these devices were permitted under prior law.

Information reporting and public approval requirements

The bill clarifies that the extensions of the information reporting requirement to all bonds and of the public approval requirement to all private activity bonds apply to bonds issued after December 31, 1986. Bonds that were subject to these requirements under prior law continued to be so subject if issued between August 15, 1986, and January 1, 1987.

Repeal of qualified mortgage bond policy statement requirement

The bill clarifies that the repeal of the annual policy statement requirement for qualified mortgage bonds was effective for refunding bonds (as well as new money issues) issued after August 15, 1986.

15. Transitional exceptions

Present Law

Transitional exception for certain advance refundings

A transitional exception to various requirements of the Act is provided for certain advance refunding bonds. Bonds that were IDBs or private loans bonds under prior law may not be advance refunded under this exception.

Refundings of certain bonds issued pursuant to transitional exceptions

Bonds issued pursuant to general transitional exceptions

The Reform Act includes general transitional exceptions for certain bonds for facilities that were "in progress" on September 25, 1985 (Reform Act. 1312), and for certain current refundings of bonds originally issued before August 16, 1986 (Reform Act sec. 1313)).

As is true with other types of bonds, the Reform Act permits certain current refunding of mortgage revenue bonds and student loan bonds to occur without regard to the new targeting rules of the Act. The legislative history accompanying the Reform Act states that refundings are not intended to qualify for this transitional exception if the period for originating loans under the refunding bonds extend more than three years after the date the refunded (original bonds in the case of a series of refundings) bonds were issued.

Bonds issued pursuant to certain project-specific exceptions

Under the Reform Act, project-specific transitional exceptions generally are limited to a specified amount of bonds (Reform Act secs. 1316(g) and 1317). The treatment of current refunding issues for purposes of these limitations is not specified.

Treatment for volume limitation purposes

Advance refundings of certain output facility bonds

The State private activity bond volume limitations generally are effective for bonds issued after August 15, 1986. Transitional exceptions are provided under specified circumstances (Reform Act sec. 1315).

A special rule applies to advance refundings of bonds issued before August 16, 1986, if the bonds were governmental bonds when issued. Under this rule, the refunding bonds are subject to the volume limitation, to the extent of the nongovernmental use of issue in excess of $15 million, if 5 percent or more of the proceeds of the issue was used to finance output facilities (other than facilities for furnishing water).

Qualified redevelopment bonds

Under the Reform Act, bonds issued pursuant to project-specific transitional exceptions (Reform Act sec. 1317), and which would not have been subject to volume limitations under prior law, are exempt from the new private activity bond volume limitation.

The Reform Act provides project-specific transitional exceptions for bonds to finance several redevelopment projects (Reform Act sec. 1317(6)). The Reform Act specifies that bonds issued pursuant to these exceptions are to be treated as bonds which would not have been subject to volume limitations under prior law. (*See, Reform Act sec. 1315(e).)*

Treatment under alternative minimum tax of bonds issued pursuant to transitional exceptions

Interest on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986,[9] is treated as a preference item for purposes of the alternative minimum tax. This treatment does not apply to refundings (including a series of refundings) of bonds originally issued before August 8,. 1986.

Under a special provision, interest on bonds issued pursuant to certain project-specified transitional exceptions (Reform Act sec. 1317) is not treated as a preference item, if the bonds would not have been IDBs or private loan bonds under prior law. Bonds issued pursuant to the general transitional exceptions for certain "in progress" facilities and for certain refunding bonds, as well as exceptions for bonds transitioned under prior tax Acts which exceptions are reenacted (Reform Act sec. 1316(g)), are not eligible for this exception. Interest on these bonds is therefore a preference item under the alternative minimum tax if the bonds are private activity bonds, as defnied under present law.

Carryforwards for certain bonds issued pursuant to transitional exceptions

The Reform Act contains no general rule allowing volume cap carryforwards for bonds issued pursuant to transitional exceptions. Certain transitioned bonds (e.g., bonds which are specifically described as belonging to a category for which carryforward elections are permitted under present law) may qualify for carryforward elections under the substantive volume limitations rules.

Project-specific transitional exceptions

The Reform Act provides transitional exceptions to indicated provisions for various specifically described projects.

Explanation of Provisions

Transitional exception for certain advance refundings

Under the Reform Act, bonds that were IDBs or private loan bonds under prior law do not qualify under the transitional exception for certain advance refunding bonds (Reform Act sec. 1313(b)). The bill clarifies that the determination of whether a bond was a private loan bond is to be made without regard to any exception to the private loan bond definition, except the exception for so-called "excluded loans" (former sec. 103(o)(2)(C)). Thus (e.g.), IDBs, mortgage revenue bonds and student loan bonds are treated as private loan bonds for purposes of this provision, and may not be advance refunded under the transitional rule; however, bonds used to make loans that enable the borrower to finance a governmental tax or assessment of general application for an essential government function may qualify under the transitional exception provided the tax-assessment bonds would not have been IDBs under the prior-law definition.

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[9] This date is extended to August 31, 1986, in the case of certain bonds that were governmental bonds under prior law.

Refundings of certain bonds issued pursuant to transitional exceptions

Bonds issued pursuant to general transitional exceptions

"In-progress" project rule.—The bill clarifies the conditions under which bonds issued pursuant to the general transitional exception for certain "in-progress" projects (Reform Act sec. 1312) may be currently refunded, while continuing to qualify for transitional relief. Such bonds are required to meet and satisfy both (a) the provisions of the Reform Act that apply to bonds issued under the transitional exception for in-progress projects (Reform Act sec. 1312(b)(1)), and (b) the provisions that apply under the general transitional exception for current refunding bonds (Reform Act sec. 1313(b)(3)).

Qualified mortgage bonds and student loan bonds.—The bill liberalizes and codifies the statements in the legislative history concerning the maximum loan origination periods for refundings of qualified mortgage bonds and student loan bonds. Under the bill, the new targeting rules for qualified mortgage bonds apply to all loans made from the proceeds of refunding bonds, which loans are orginated more than three years after the date the refunded bonds (original bonds in the case of a series of refundings) were issued. This requirement applies both to loans originated from original proceeds of the borrowing and to loans originated from prepayments of mortgage loans.

Similarly, in the case of student loan bonds, the new Code requirements apply to loans originated more than three years after the date the refunded bonds (original bonds in the case of a series of refundings) were issued. In the case of refundings of student loans issued in connection with the Federal GSL and PLUS programs, the applicable requirements are those for GSL and PLUS program bonds issued under the 1986 Code. The rule does not permit conversion of these Federally guaranteed bonds into supplemental student loan bonds.

These codifications for mortgage revenue bonds and student loan bonds apply to refunding bonds issued after October 16, 1987.

Bonds issued pursuant to certain project-specific exceptions

Where a transitional exception is limited to a specified amount of bonds (Reform Act secs. 1316(g) and 1317), the bill clarifies that bonds issued pursuant to the exception may be currently refunded, under specified circumstances, without the refunding counting against this dollar limit. This allowance applies to a refunding (including a series of refundings) of a transitioned bond, provided that—

(a) the weighted average maturity of the refunding issue does not exceed the weighted average maturity of the refunded bonds;

(b) the amount of the refunding bond does not exceed the outstanding principal amount of the refunded bond; and

(c) the refunded bond is redeemed within 90 days of the issuance of the refunding bond.

Treatment for volume limitation purposes

Advance refundings of certain output facility bonds

The bill clarifies that the rule subjecting the private use portion of advance refundings of pre-August 16, 1986, bonds to the State private activity bond volume limitations, if 5 percent or more of the net proceeds were used for output facilities, applies notwithstanding the general transitional exception contained in Reform Act section 1315 for certain bonds that were governmental bonds under prior law.

Qualified redevelopment bonds

Qualified redevelopment bonds that are the subject of project-specific transitional exceptions (Reform Act sec. 1317(6)) generally are exempt from the new State volume limitations. The bill clarifies that this treatment does not apply to any bonds issued pursuant to these exceptions which would have been tax-exempt IDBs (as defined under the 1954 Code) if the bonds had been issued before August 16, 1986. (Bonds for a purpose that would not have qualified for tax-exemption under prior law may not be issued under these transitional exceptions.)

This provision is effective for bonds issued after June 10, 1987.

Treatment under alternative minimum tax of bonds issued pursuant to transitional exceptions

The bill clarifies the treatment under the individual and corporate alternative minimum taxes of interest on bonds issued pursuant to various transitional exceptions. Under this clarification, interest on bonds issued pursuant to transitional exceptions generally is not treated as a preference item for purposes of the individual or corporate alternative minimum taxes, unless the bonds would have been IDBs or private loan bonds if issued on August 7, 1986. This clarification applies to bonds issued pursuant to the general transitional exceptions for certain bonds (Act sec. 1312), the continuing exceptions for certain bonds that received transitional relief under prior tax acts (Act sec. 1316(g)), and project-specific transitional exceptions (Reform Act sec. 1317). The clarification does not apply to refunding bonds which are subject to the transitional exceptions contained in the minimum tax provisions of the Reform Act.

Carryforwards for certain bonds issued pursuant to transitional exceptions

The bill clarifies that carryforward elections under the new State volume limitations are permitted for bonds (except qualified small-issue bonds) issued pursuant to transitional exceptions (e.g., bonds authorized under Reform Act secs. 1312 and 1317).

Amendments to project-specific transitional exceptions

The bill clarifies that the new limitations on bond-financing of costs of issuance (sec. 147(g)) apply to bonds issued pursuant to project-specific transitional exceptions (Reform Act sec. 1317), unless otherwise expressly provided.

The bill further makes various amendments to project-specific transitional exceptions contained in the Reform Act. Among these amendments is a clarification that bonds authorized to be issued in excess of the $150 million limitation on outstanding nonhospital bonds for section 501(c)(3) organizations under the project-specific transitional exceptions are in addition to any such bonds authorized under a generic transitional exception to the Reform Act (Reform Act sec. 1313(b)). Further, issuers may elect which exception to apply first—the project-specific exception or the generic exception. All transitioned bonds count toward the $150 million limit in determining the amount of additional bonds from which a section 501(c)(3) organization may benefit in the future.

The committee further wishes to clarify a question as to the order in which bonds issued pursuant to project-specific transition rules must be issued. The committee intends that these transitional bonds need not be the first bonds issued by the issuer after the effective date of the new provisions. For example, if bonds are issued to finance airport facilities and the issue qualifies under all provisions of the Reform Act, these bonds do not count against any transitional exception provided for that airport. Thus, a subsequent issue may be issued containing the full amount of the transitioned bonds.

XIV. Trust and Estates; Unearned Income of Certain Minor Children; Generation-Skipping Transfer Tax (Sec. 6676 of the Bill)

A. Income Taxation of Trusts and Estates

1. Grantor treated as holding any power or interest of grantor's spouse (sec. 6676 of the bill, sec. 1401 of the Reform Act, and sec. 672 of the Code)

Present Law

The grantor of a trust is treated as the owner of the trust assets if he retains certain powers or interests over all or a portion of the trust (sec. 671–678). In that situation, the income and deductions of the portion are taxed directly to the grantor. The grantor is not, however, treated as the owner by virtue of certain powers exercisable by trustees, none of whom is the grantor and not more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. The grantor is also treated as the owner of a trust if the trust makes certain loans to him.

The grantor is treated as holding all powers and interests of the grantor's spouse if the grantor's spouse is living with the grantor when such interests and powers are created.

Explanation of Provision

The biil provides that the grantor will be treated as holding any power or interest that was held by an individual either (1) who was the grantor's spouse at the time that the power or interest was created or (2) who became the grantor's spouse subsequent to the creation of that power or interest. For this purpose, individuals are not considered married if they are legally separated under a decree of divorce or of separate maintenance.

In addition, the grantor is treated as owner of a trust by virtue of certain powers exercisable by trustees if the grantor's spouse is a trustee or more than half of the trustees are related or subordinate parties subservient to the wishes of the spouse. The grantor is also treated as the owner where the trust makes certain loans to the grantor's spouse.

2. Limitations to reversionary interest rule exceptions (sec. 6676 of the bill, sec. 1402 of the Reform Act, and sec. 673 of the Code)

Present Law

The grantor is treated as the owner of trust property where the grantor or the grantor's spouse has a reversionary interest whose value is more than 5 percent of the value of the trust at the time of the inception of the trust.

Explanation of Provision

The bill provides that, in determining whether a reversionary interest has a value in excess of 5 percent of the trust, it will be assumed that any discretionary powers are exercised in such a way as to maximize the value of the reversionary interest. In addition, the bill reenacts a provision of prior law which provides rules for postponements of the date of a reversionary interest. This provision was deleted by the Act, but is necessary where the date of the reversionary interest is after the life of an individual and that date is later postponed.

3. Taxable year of trusts (sec. 6676 of the bill and sec. 1403 of the Reform Act)

Present Law

Trusts are required to use a calendar year as their taxable year, effective for taxable years beginning after December 31, 1986. The taxable income of any beneficiary of a trust that is attributable to the trust's short taxable year arising from a required change of its taxable year to a calendar year is to be included in the beneficiary's income over a four year period beginning with the year of change.

Explanation of Provision

The bill provides that the four year spread from a required change of a taxable year also is available to beneficiaries of charitable remainder trusts (described in sec. 664).

The bill also specifies that any trust beneficiary may elect to include the taxable income attributable to the required change in the trust's taxable year in the following year. The committee intends that trusts and estates required to change their taxable year annualized any income earned in the short year.

4. Application of four year spread to tiered pass-through entities (sec. 6676 of the bill, and secs. 806 and 1403(c) of the Reform Act)

Present Law

Owners of partnerships, S corporations, common trust funds and trusts are permitted to take income attributable to the short taxable year required by reason of changes made in the 1986 Act over the four year period beginning in such year.

Explanation of Provision

The bill clarifies that a pass-through entity which is required to change its taxable year by the 1986 Act and owns an interest in a pass-through entity that also was required to change its taxable year by the 1986 Act will not be allowed the four year spread with respect to income earned from such entity. A pass-through entity is any partnership, S corporation, common trust fund or trust.

5. Estimated taxes of trusts and estates (sec. 6676 of the bill, sec. 1404 of the Reform Act, and sec. 6654 of the Code)

Present Law

Trusts and estates are generally required to pay estimated taxes in the same manner as individuals. Estates do not, however, pay estimated taxes for taxable years ending within two years of the decedent's death. Such treatment does not extend to revocable trusts, which sometimes serve as estate substitutes.

Within 65 days of the close of death of the trust's taxable year, the trustee may elect, in substance, to distribute any excess estimated payments to the trust beneficiaries. This election is made on the trust's tax return for that year.

A taxpayer may satisfy the obligation to pay estimated taxes by paying an annualized income installment which is computed by placing income for the months in the year ending before the due date of the installment of an annualized basis.

Explanation of Provision

The bill exempts a grantor trust which receives the residual of the probate estate under the grantor's will from payment of estimated taxes with respect to taxable years ending before two years after the grantor's death.

The bill provides that the individual estimated tax provisions do not apply to a trust subject to tax under section 511 or to any private foundation.[1] In addition, the bill clarifies that the election to distribute excess estimated tax payments to beneficiaries need not be made on the tax return for the trust for the preceding year, but may be made in a manner prescribed by the Secretary of the Treasury.

The bill provides that a trust or estate's annualized income installment must be computed by placing income for the months in the year ending before the date one month prior to the due date of the installment on an annualized basis.

B. Taxation of Unearned Income of Minor Children (Sec. 6676 of the bill, Sec. 1411 of the Reform Act, and Secs. 1 and 59 of the Code)

Present Law

The unearned income of a child under age in excess of $1,000 is taxed to the child at the highest marginal rate of the child's parents. This tax is determined by calculating the additional tax that the parents would pay if the parents' income included the unearned income of the child in excess of $1,000. In making this calculation, the amount of the parents' deductions and credits are not affected by the inclusion of any of the child's unearned income in the parents' income. The Secretary of the Treasury is to issue regulations providing for the application of these rules where the minor child or his parents is subject to the alternative minimum tax.

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[1] See section 115(h) of the bill, clarifying the application of the corporate estimated tax requirements to these organizations.

Where an individual transfers appreciated property to a trust and the trust disposes of such property within 2 years of the transfer, the tax on the built-in gain at the time of the transfer to the trust is determined at the highest marginal rate of the transferor for the year of sale (sec. 644).

Explanation of Provisions

Computation of child's tax where parent's rates are used to determine tax of trust

The bill provides that, where parents' marginal tax brackets are being used to determine both the income tax of a trust under section 644 and income tax of their minor children under section 1(i), the tax of the trust is determined first without regard to the income of the minor child and then the tax of the minor child is determined second by including the gain of the trust which is taxable under section 644 in the income of the parent. The bill also provides that the determination of the tax of the child does not affect that amount of any "exclusion," as well as any deduction or credit, of the parents.

Alternative minimum tax

The bill also provides that the alternative minimum tax imposed on the net unearned minimum taxable income of a child under 14 years of age will not be less than the alternative minimum tax which would have been imposed on the parents had that income been included in the parents' alternative minimum taxable income. The amount of minimum tax which would have been imposed on the parents is computed by including the child's net unearned minimum taxable income in the alternative minimum taxable income of the parents, and by increasing the parents' regular tax by the amount of the child's regular tax imposed on the net unearned income of the child. For this purpose, net unearned minimum taxable income means net unearned income (i.e., unearned income in excess of $1,000) computed by taking into account the preferences and adjustments provided in sections 56, 57 and 58.

For example, assume that the child's net unearned income (as defined in section 1(i)(4)) is $10,000 and the unearned minimum taxable income (as defined in section 59(j)(3) as added by the bill) is $20,000, by reason of the child having $10,000 of tax-exempt interest on newly issued private activity bonds. Assume that the parents are subject to the alternative minimum tax for the taxable year and that the parents' marginal rate for purposes of the regular tax is 28 percent. Under the rules of section 1(i), the child's regular tax on the net unearned income is $2,800. The child is not subject to the alternative minimum tax (determined without regard to this provision) by reason of the $30,000 exemption amount. Under the bill, the child's minimum tax will be $1,400 (21 percent of $20,000 ($4,200) less 28 percent of $10,000 ($2,800)). If, however, the parents would not have been subject to the alternative minimum tax (taking into account the net unearned minimum taxable income and the regular tax of the child) because their regular tax exceeded their tentative minimum tax, no minimum tax would be imposed on the child.

C. Generation-Skipping Transfer Tax

1. Overlap of direct skips and taxable terminations and distributions (sec. 6676 of the bill, sec. 1431 of the Reform Act, and sec. 2612 of the Code)

Present Law

A "direct skip" is defined as a transfer subject to estae or gift tax of an interest in property to a skip person. A "taxable termination" is defined as a termination of an interest in property held in trust if (1) there is no nonskip person who has an interest in the trust after the termination or (2) at no time after the termination may a distribution be made from that trust to a nonskip person. A "taxable distribution" is defined as a distribution from a trust to a skip person (other than a taxable termination or a direct skip).

Excluded from the definition of direct skips are (1) certain transfers to a grandchild, where the parent of the grandchild is dead (the predeceased parent rule) and (2) certain transfers prior to January 1, 1990, of less than $2 million (the $2 million exemption).

Explanation of Provision

The bill provides that, where a transfer meets the definitions of a direct skip and a taxable termination or distribution, the transaction will be treated as a direct skip. For example, where an individual transfers property into a trust that is to pay income to that individual for his life and, after that individual's death, to pay the remainder to that individuals's grandchild, there is both a direct skip and a taxable termination under present law at the death of that individual. Under the bill, the transfer would be treated as a direct skip from the individual to the individual's grandchild (and not a taxable termination) at the time of that individual's death.

The bill also clarifies that transfers which do not constitute direct skips because of the deceased parent rule or the $2 million exemption also do not constitute taxable terminations or distributions.

2. Special rule for determination of inclusion ratio where inter vivos transfers are includible in transferor's gross estate (sec. 10214(f)(5) of the bill, sec. 1431 of the Reform Act, and sec. 2642 of the Code)

Present Law

The inclusion ratio is used to establish the rate of tax which is imposed on the generation-skipping transfer. It is the ratio the numerator of which is the amount of the $1 million exemption allowed to every individual that the transferor has allocated to every individual that the transferor has allocated to a particular transfer and the denominator of which is the value of the property transferred to the trust reduced by any Federal or State death taxes recovered from the trust and the present value of any charitable interests in the trust. Where any of the $1 million exemption is allocated to property transferred at or is its value for Federal estate tax purposes. Where any of the $1 million exemption is allocated on a timely filed gift tax return, the value of the property is its value for Federal gift tax purposes. Where any of the $1 million is allocated during the lifetime of the transferor but not on a timely filed gift tax return, the value of the property is determined at the time that the allocation is filed with the Internal Revenue Service.

Explanation of Provision

The bill provides that no allocation of any portion of the transferor's $1 million exemption may be made to any portion of property that is transferred by the transferor during his lifetime, but would be includible in the transferor's gross estate (other than pursuant to sec. 2035) until the earlier of the date of a generation-skipping transfer with respect to the property or the transferor's death. The value of property for purposes of determining the inclusion ratio shall be its value for Federal estate tax purposes. If such transfer is a direct skip to a trust, such skip will be treated as occurring on the earlier of the date of a generation-skipping transfer from the trust with respect to the property or the death of the transferor.

3. Definition of skip person involving trusts (sec. 6676 of the bill, sec. 1431 of the Reform Act, and sec. 2613 of the Code)

Present Law

Under present law, a "skip person" is defined to mean either (1) a person assigned to a generation that is two or more generations below that of the transferor or (2) a trust all the interests of which are held by such persons and which at no time can make distributions to persons assigned to a generation less than two generations below that of the transferor (sec. 2613(a)). Also under present law, a trust generally is treated as a person (sec. 7701(a)(1)).

If an estate, trust, partnership, corporation, or other entity has an interest in property, each individual having a beneficial interest in such entity is treated as having an interest in that property and is assigned to a generation under normal generation assignment rules consistent with that beneficial interest (sec. 2651(e)(2)).

Explanation of Provision

The bill clarifies the definition of a "skip person" by providing that a skip person must be a "natural person" whose generation assignment is two or more generations below that of the transferor (i.e., category (1), above). In addition, the bill provides that the determination of whether a trust is a "skip person" (i.e., category (2), above) is to be determined without regard to the entity look-through rules as they apply to trusts.

4. Disregard of support obligations as an interest (sec. 6676 of the bill, sec. 1431 of the Reform Act, and sec. 2652 of the Code)

Present Law

In order to determine whether there is a taxable termination (sec. 2612(a)), whether property is transferred to a skip person (sec. 2612(c)), and whether property qualifies for the $2 million exemption for transfers to grandchildren, it is necessary to determine which persons have an "interest" in the trust. A person generally is treated as having an interest held in trust if that person has a right (other than a future right) to receive income or corpus from a trust or is a permissible current recipient of income or corpus from the trust.

Explanation of Provision

The bill provides that any income or corpus of the trust that may be used to satisfy any obligation of support arising by reason of State law is to be disregarded in determining whether a person has an interest in a trust if such use is discretionary or pursuant to any State law substantially equivalent to the Uniform Gifts to Minors Act. Thus, a parent is not treated as having an interest in a trust by reason of powers he may have as a guardian for the child. On the other hand, a parent will be treated as having an interest in the trust if the trust instrument mandates that trust assets be used to discharge a support obligation.

5. Taxation of multiple skips (sec. 10214(f)(8) of the bill, sec. 1431 of the Reform Act, and sec. 2653 of the Code)

Present Law

There is no generation-skipping transfer tax on what otherwise would be a direct skip where property is transferred from the transferor to the grandchild of the transferor or a trust for the benefit of such a grandchild if the parent of the grandchild is deceased at the time of the transfer (sec. 2612(c)). This is accomplished by deeming the generation assignment of the grandchild to "step up" to the generation of the child.

Where property held in trust has been the subject of a generation-skipping transfer tax and the property remains in trust, the transferor of the property remaining in trust for purposes of subsequent applications of the generation-skipping transfer tax is deemed to be in the generation one higher than the generation of the beneficiary or beneficiaries with the highest generation. In effect, the generation of the transferor "drops down" to one generation older than that of the eldest beneficiaries of the trust. There is no "drop down" of the transferor where the property is exempt from the generation skipping tax by reason of the predeceased child exception of section 2612(c). Thus, if property is transferred by a grandparent to a trust for the exclusive benefit of the transferor's grandchild, distributions from the trust to the grandchild would be taxable distributions even though the grandchild's parents were deceased when the trust was created.

Explanation of Provision

The bill provides that the generation "drop-down" rule of section 2653(a) applies where there would have been a generation-skipping transfer but for the predeceased child rule of section 2612(c). Thus, where a grandparent transfers property to a trust which is to pay income to the grandparent's grandchild for life, distributions to the grandchild would not be taxable distributions if the grandchildren's parents were deceased at the time of the transfer to the trust.

6. Certain interests disregarded (sec. 6676 of the bill, sec. 1431 of the Reform Act, and sec. 2652(c)(2) of the Code)

Present Law

The determination of whether a trust is a generation-skipping trust depends upon whether a beneficiary has an "interest" in the trust. A person generally has an interest in property if that person has a right (other than a future right) to receive income or corpus from the trust or is a permissible current recipient of income or corpus from the trust. Nonetheless, present law provides that an interest that is used primarily to postpone or avoid the generation-skipping transfer tax is disregarded in applying the generation-skipping transfer tax.

Explanation of Provision

The bill clarifies the rule of present law that disregards interests primarily used to postpone or avoid the generation-skipping transfer tax by removing any indication that the interest to be disregarded must be nominal and by providing that the rule applies if the primary purpose of the interest is to avoid any generation-skipping transfer tax. For example, if a transferor placed property in trust which is to pay income to a great grandchild for a relatively short period, then income to a grandchild for life, with remainder going back to a great grandchild, in order to avoid a second imposition of the generation-skipping transfer tax, the income interest of the great grandchild would be disregarded so that there would be a generation-skipping transfer tax at the death of the grandchild. That interest would be disregarded even though distributions to the great grandchild are taxable distributions under present law.

7. Definition of transferor (sec. 6676 of the bill, sec. 1431 of the Reform Act, and sec. 2652 of the Code)

Present Law

The term "transferor" is defined to mean the decedent, in the case of a transfer of a kind subject to the Federal estate tax, or the donor, in the case of a transfer of a kind subject to the Federal gift tax. In some cases, it is possible for property to be subject to Federal estate or gift tax even though there is no transfer of such property under local law at such time. For example, in the case of a trust which is to pay income to the transferor for life, then income to the transferor's child for life, remainder to the transferor's grandchild, the property is includible in the gross estate of the transferor, even though there is no transfer of the trust assets under local law at the time of the transferor's death.

Explanation of Provision

The bill clarifies the definition of "transferor" by providing that a person is treated as the transferor of any property included in the gross estate of that person or which that person has made a gift. Thus, a person can be a transferor even though there is not a transfer of property under local law. The transferor is treated as transferring any property with respect to which that person is the transferor.

8. Regulatory authority to prescribe rules dealing with trust equivalents (sec. 6676 of the bill, sec. 1431 of the Reform Act, and sec. 2663 of the Code)

Present Law

The generation-skipping transfer tax is imposed on generation-skipping trusts. For this purpose, a trust is any arrangement (other than an estate) which has substantially the same effect as a trust. Examples of such arrangements include life estates and remainders, estates for years, and insurance and annuity contracts.

Explanation of Provision

The bill provides the Secretary of the Treasury with authority to prescribe regulations modifying the generation-skipping transfer tax rules generally applicable to trusts in the case of trust equivalents. For example, where the generation-skipping arrangement is in the form of an insurance or annuity contract, it is possible that the Secretary of the Treasury may exercise the authority granted by this section of the bill to provide that the beneficiary of the insurance or annuity contract pay any generation-skipping transfer tax.

9. Generation assignment of governmental entities (sec. 6676 of the bill, sec. 1431 of the Reform Act, and sec. 2651(e)(3) of the Code)

Present Law

In general, persons who are related to the transferor are assigned to a generation based upon their relationship to the transferor. Persons who are not related to the transferor are assigned to a generation based upon the difference in age between that person and the transferor. Charitable organizations (described in secs. 511(a)(2) and (b)(2)) are assigned to the same generation as that of the transferor.

Explanation of Provision

The bill provides that any governmental entity is assigned to the same generation as that of the transferor. The rule applies to all governmental entities, including the United States Government, the government of any State, and the government of any foreign country.

10. Basis of property after a taxable termination (sec. 6676 of the bill, sec. 1431 of the Reform Act, and sec. 2654 of the Code)

Present Law

Where property is subject to a generation-skipping transfer tax, the basis of the property immediately after the generation-skipping transfer tax generally is its basis immediately before the imposition of the generation-skipping transfer tax increased (but not in excess of the property's fair market value at such time) by the portion of the generation-skipping transfer tax attributable to any appreciation in the property at such time. Nonetheless, where property that is entirely subject to a generation-skipping transfer tax at the same time as and as a result of the death of an individual, the basis of the property immediately after the imposition of the generation-skipping transfer tax generally is its fair market value at such time. Where only a portion of the property is subject to the generation-skipping transfer tax (because the inclusion ratio is less than 1), any increase in basis to the property's fair market value basically is limited to the portion of the property subject to the generation-skipping transfer tax (i.e., the amount of appreciation in the property multiplied by the inclusion ratio).

Explanation of Provision

The bill provides that where the basis of property that has been subject to a generation-skipping transfer tax is to be determined by reference to its fair market value (because the generation-skipping transfer tax occurs at the same time as and as a result of the death of an individual) and the inclusion ratio is less than 1, any decrease in basis (as well as any increase in basis) is limited by the decrease in the value of such property multiplied by the inclusion ratio.)

11. Treatment of single trust as multiple trusts (sec. 6676 of the bill, sec. 1431 of the Reform Act, and sec. 2654 of the Code)

Present Law

The generation-skipping transfer tax is imposed on direct skips and taxable terminations and taxable distributions from a generation-skipping trust. The impact of the generation-skipping transfer tax sometimes depends upon whether assets are transferred in one trust or in more than one trust. For example, where transfers that qualify for the $10,000 annual exclusion are made to a generation-skipping trust that has an inclusion ratio greater than zero, a portion of such transfers may later be subject to a generation-skipping transfer tax as a taxable termination or taxable distribution, even though such transfers would never be subject to the generation-skipping transfer tax if made to a separate trust that has a zero inclusion ratio.

Explanation of Provision

The bill provides that a single trust generally may not be treated as two separate trusts for purposes of the generation-skipping transfer tax. However, portions of a trust attributable to transfers from different transferors, and substantially separate and independent shares of different beneficiaries in a trust, shall be treated as separate trusts.

The bill does not affect the treatment of trusts which are separate trusts under state law.

12. Special election for qualified terminable interest property (sec. 6676 of the bill, sec. 1431 of the Reform Act, and sec. 2652(a)(3) of the Code)

Present Law

The term "transferor" is defined to mean the decedent, in the case of a transfer of a kind subject to the Federal estate tax, or the donor, in the case of a transfer of a kind subject to the Federal gift tax.[2] In the case of any property which has been elected to be treated as qualified terminable interest property (QTIP) for gift or estate purposes, the estate of the decedent or the donor spouse may elect to treat the property for generation-skipping transfer tax purposes as if no QTIP election had been made. Thus, under the election, for generation-skipping tax purposes, the donor or decedent spouse would be treated as the transferor with respect to property which would for estate and gift tax purposes be treated as passing to the donee or surviving spouse.

Explanation of Provision

The provision clarifies that the election to treat property as is no QTIP election had been made must be made with respect to all the property in the QTIP trust. For example, if a spouse makes a QTIP election with respect to $1.4 million of a $2 million trust, he must, to make the generation-skipping election, elect with respect to the entire $1.4 million.

13. Certain partial terminations treated as taxable (sec. 6676 of the bill, sec. 1431 of the Reform Act and sec. 2612(a) of the Code)

Present Law

If a taxable termination occurs with respect to a trust at the same time as and as a result of the death of an individual, an election may be made to value the property included in the termination under the alternate valuation provided in section 2032.

If, upon the termination of an interest in property held in trust, a specified portion of the trust assets are distributed to certain persons, the termination shall be considered a taxable termination with respect to such portion of trust property and will be eligible for alternate valuation. This treatment is limited to distributions to skip persons who are lineal descendents of the holder of the interest.

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[2] The bill would replace "a transfer of a kind" with "and property."

Explanation of Provision

The bill provides that the distribution of a specific portion of trust assets will be treated as a taxable termination only if it is upon the termination of an interest in property by reason of the death of a lineal descendant of the transferor. Such treatment will be available to all skip persons.

14. Treatment of certain nonreportable gifts (sec. 6676 of the bill, sec. 1431 of the Reform Act, and sec. 2642(c) of the Code)

Present Law

The applicable rate for the generation-skipping transfer tax equals the maximum Federal estate tax rate times the inclusion ratio with respect to the transfer. For trusts, the inclusion ratio equals the excess of one over a fraction, the numerator of which is the amount of GST exemption allocated to the trust, and the denominator of which is the value of the property tranferred to the trust, with certain reductions.

A nontaxable gift is any transfer of property to the extent such transfer is not treated as taxable because of certain exclusions. Nontaxable gifts which are direct skips have a zero inclusion ratio. Nontaxable gifts to trusts which are not direct skips generally do not change the inclusion ratio of the trust. The effect of a nontaxable gift which is a direct skip to a trust upon the trust's inclusion ratio is unclear.

Explanation of Provision

The bill replaces the term nontaxable gift with nonreportable gift. A nonreportable gift is any gift to an individual if all such gifts to such individual during the calendar year are not taxable by virtue of certain exclusions. For example, assume that an individual transfers property which wholly qualifies for the $10,000 annual gift tax exclusion to a newly created generation-skipping trust in 1988. The bill clarifies that the inclusion ratio applicable to that trust is zero. However, if the gift exceeds the $10,000 exclusion, a generation-skipping tax exemption amount equal to the entire value of the trust will need to be applied to the trust in order to maintain the inclusion ratio at zero.

The bill clarifies that any nonreportable gift to an trust which is a direct skip will not affect the inclusion ratio of the trust.

15. Effective date of the revised generation-skipping transfer tax (sec. 6676 of the bill and sec. 1433 of the Reform Act)

Present Law

The revised generation-skipping transfer tax generally applies to transfers made after the date of enactment of the Reform Act (October 22, 1986). In addition, the revised generation-skipping transfer tax applied to inter vivos transfers made after September 25, 1985.

The generation-skipping transfer tax does not apply, however, to—

(1) inter vivos transfers made before September 26, 1985,

(2) trusts that were irrevocable before September 26, 1985, except for additions of corpus to such trusts after September 25, 1985,

(3) testamentary tranfers made pursuant to will in existence before the date of enactment of the Reform Act (October 22, 1986) if the decedent died before January 1, 1987, and

(4) transfers under a trust to the extent that such trust consists of property included in the gross estate of the decedent or which are direct skips which occur by reason of the death of any decedent if the decedent was incompetent or the date of enactment of the Reform Act (October 22, 1986) and at all times thereafter until death.

Explanation of Provision

The bill clarifies that the grandfather of irrevocable trust created before September 25, 1985, applies whether or not income derived from corpus contributions before September 26, 1985, is distributed or accumulated. The bill also provides that the grandfather of transfers made pursuant to wills in existence on the date of enactment of the Reform Act (October 22, 1986) if the decedent dies before January 1, 1987, also applies to transfers pursuant to revocable trusts which were in existence on the date of enactment of the Reform Act (October 22, 1986) if the decedent dies before January 1, 1987.

16. $2 million exemption (sec. 6676 of the bill and sec. 1433 of the Reform Act)

Present Law

The revised generation-skipping transfer tax on direct skips does not apply to transfers before January 1, 1990, from a transferor to a grandchild of the transferor to the extent that the aggregate transfers from that transferor to the grandchild do not exceed $2 million. An election may be made to treat inter vivos and testamentary contingent tranfers in trusts for the benefit of a grandchild as direct skips if (1) the transfers occur before the date of enactment of the Reform Act (October 22, 1986), and (2) the transfers would be direct skips except for the fact that the trust instrument provides that, if the grandchild dies before vesting of the interest transferred, the interest is transferred to the grandchild's heirs (rather than the grandchild's estate). Transfers treated as direct skips as a result of this election are subject to Federal gift and estate tax on the grandchild's death in the same manner as if the contingent gift over had been to the grandchild's estate.

Explanation of Provision

The bill clarifies the application of the $2 million exemption in three respects. First, the bill clarifies that a transfer to a trust is treated as a transfer to a grandchild if (1) no amount may be distributed to any person other than that grandchild during the life of the grandchild, (2) the assets will be includible in the gross estate of the grandchild if the grandchild dies before the termination of the trust, and (3) all of the income of the trust after the child has reached age 21 must be distributed to the grandchild not less often than annually. The third requirement applies only to tranfers after June 10, 1987. The committee intended that the third requirement would not be satisfied by a so-called *Crummy* power.

Second, the bill clarifies that trusts which are eligible for the $2 million exemption are treated as if that trust had been subject to the generation-skipping transfer tax and, consequently, that distributions out of a trust to such a grandchild are not treated as taxable distributions.

Third, the bill amends the special rules applicable to transfers in trust before the date of enactment of the Reform Act (sec. 1433(d) of that Act) by (a) clarifying that transfers to such trusts are treated as transfers to a grandchild (and, therefore, eligible for the $2 million exclusion) and (b) providing that the executor of the grandchild can recover the additional estate taxes imposed upon the estate of the grandchild by reason of the election from that person or persons receiving the property unless the will of the grandchild provides otherwise.

XV. Compliance and Tax Administration Provisions (Sec. 6677 of the Bill)

1. Nominee reporting by partnerships (sec. 6677(a) of the bill, sec. 1501 of the Reform Act, and sec. 6724(d)(2)(B) of the Code)

Present law

Present law requires that any person holding an interest in a partnership as a nominee for another person must furnish to the partnership the name and address of that other person (along with any additional information required by regulations) (Code sec. 6031(c)). Failure by the nominee to provide this information to the partnership is not subject to the general penalty for failure to file information reports as required.

Explanation of Provision

The bill provides that a nominee's failure to supply the required information to the partnership is subject to the general penalty for failure to furnish payee statements (sec. 6722). This penalty is $50 per failure, up to a maximum of $100,000 per calendar year.

2. Negligence and fraud (sec. 6677(b) of the bill, sec. 1503 of the Reform Act, and secs. 6013(b)(5), 6601(e), and 6653 of the Code)

Present Law

Taxpayers are subject to penalties if any part of an underpayment of tax is due to negligence or fraud (Code sec. 6653). Both of these penalities have two components. The first component of each penalty is the basic penalty (5 percent of the entire understatement in the case of negligence, 75 percent of the portion attributable to fraud in the case of fraud). The second component of each penalty is an amount equal to one-half the interest payable on the portion of the underpayment attributable to either negligence or fraud (as the case may be), for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax if that date is earlier). Interest on the negligence and fraud penalties generally begins on the date these penalties are assessed, rather than the last date prescribed for filing the return to which the penalty relates.

Explanation of Provision

The bill repeals the second, time-sensitive components of both the negligence and fraud penalties. The bill instead imposes interest on these penalties from the last date prescribed for filing the return to which the penalty relates. The bill also improves the coordination of these penalties with the provision permitting a couple to file a joint return after filing a separate return (Code sec. 6013(b)). These provisions apply to returns the due date for which (determined without regard to extensions) is after December 31, 1987.

The bill amends the negligence penalty for failure to include on a tax return amounts shown on an information return by reinstating the prior-law rule providing that the penalty is restricted to the portion of the understatement of tax attributable to the failure to report.

3. Penalty for substantial understatement of tax liability (sec. 6677(c) of the bill and sec. 1504 of the Reform Act)

Present Law

A taxpayer who substantially understates income tax for any taxable year must pay a penalty (Code sec. 6661). The Tax Reform Act of 1986 provided that this penalty is to be 20 percent of the amount of the underpayment of tax attributable to the understatement. This was effective for returns the due date of which (determined without regard to extensions) is after December 31, 1986.

After considering the Reform Act, Congress considered the Omnibus Budget Reconciliation Act of 1986 (P.L. 99-509). That Act [1] increased this penalty to 25 percent of the underpayment, effective for penalties assessed after the date of enactment of that Act. Although Congress considered the Reform Act prior to considering the Omnibus Budget Reconciliation Act, the Omnibus Budget Reconciliation Act was enacted one day before the date of enactment of the 1986 Act. [2]

Explanation of Provision

The bill provides that the increase in the substantial understatement penalty to 25 percent made by the Omnibus Budget Reconciliation Act of 1986 shall take effect as if the Tax Reform Act of 1986 were enacted on the day before the date of enactment of the Omnibus Budget Reconciliation Act of 1986.

4. Differential interest rate (sec. 6677(d) of the bill, sec. 1511 of the Reform Act, and sec. 6621 of the Code)

Present Law

The interest rate that taxpayers pay to the Treasury on underpayments of tax is one percentage point higher than the interest rate the Treasury pays to taxpayers on overpayments of tax.

Explanation of Provision

The bill corrects several cross-references to the provisions utilized to determine these rates.

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[1] Sec. 8002 of the Omnibus Budget Reconciliation Act of 1986.

[2] The Omnibus Budget Reconciliation Act of 1986 was enacted on October 21, 1986, the 1986 Act was enacted on October 22, 1986.

5. Information reporting by brokers (sec. 6677(e) of the bill, sec. 1521 of the Reform Act, and sec. 6045 of the Code)

Present Law

Persons doing business as a broker must report on specified types of transactions they effect for customers. Generally, reporting is required on sales of securities, commodities, regulated futures contracts, precious metals, and real estate.

Explanation of Provision

The bill provides that a person shall not be treated as a broker with respect to activities consisting of managing a farm on behalf of another person. This exempts farm managers from the requirement of filing a Form 1099-B with respect to their farm management activities. This information must be filed by these farm managers on a Schedule F, where it is provided in a more useful format. Consequently, filing this information on a Form 1099-B is duplicative. This provision is effective as if included in the Tax Equity and Fiscal Responsibility Act of 1982 (which generally imposed these information reporting requirements).

The bill provides that the person required to provide information returns on real estate transactions (who is generally defined as the person responsible for closing the real estate transaction) is to be called a "real estate reporting person" instead of a "real estate broker."

The bill also makes it unlawful for any real estate reporting person to charge separately any customer for complying with the information reporting requirements with respect to real estate transactions. This provision is effective on the date of enactment of the bill.

6. Information reporting on persons receiving contracts from certain Federal agencies (sec. 6677(f) of the bill, sec. 1522 of the Reform Act, and sec. 6050M of the Code)

Present Law

Present law requires that the head of each Federal executive agency file an information return with the IRS indicating the name, address, and taxpayer identification number of each person with which the agency enters into a contract. The agency must also report any additional information required under Treasury regulations. There is no exception from this information reporting in present law for contracts involving national security, confidential law enforcement, or foreign counterintelligence activities.

Explanation of Provision

The bill excepts specified types of contracts from the general information reporting requirements applicable to Federal executive agencies, and subjects those types of contracts to a different form of information reporting.

There are two types of contracts between a Federal executive agency and another person that are subject to these special rules.

The first is a contract where either the fact of the existence of the contract or the subject matter of the contract has been classified. This is accomplished by designating and clearly marking or clearly representing, pursuant to the provisions of Federal law or an Executive Order,[3] that the contract or the subject matter of the contract requires a specific degree of protection against unauthorized disclosure for reasons of national security. The second type of contract subject to the special rules is a contract involving a confidential law enforcement or foreign counterintelligence activity. In order to be eligible for these special rules, the head of the Federal executive agency (or his designee) must determine in writing that filing the information return generally required of Federal executive agencies would interfere with the effective conduct of a confidential law enforcement of foreign counterintelligence activity. This determination must be made pursuant to regulations issued by the Federal executive agency making the determination. This second type of contract involves primarily undercover operations (including sites for undercover operations) and informants.

These two types of contracts are subject to special information reporting requirements, and are exempted from the general information reporting requirements of section 6050M. The special information reporting requirements are that the IRS must first request that the Federal executive agency acknowledge whether that agency has entered into a contract with a particular person, who must be identified in the IRS request. The Federal executive agency must in response acknowledge whether it has entered into a contract with the specified person. If it has, it must provide to the IRS with respect to that person the information required to be reported under section 6050M. In addition, the agency must provide whatever additional information the agency and the Treasury agree is appropriate. The term "person" has the meaing given in section 7701(a)(1).

It is contemplated that the information provided by Federal executive agencies to the IRS under these special rules might need to be provided only to certain IRS employees, such as those with security clearances. If this is necessary, it is also contempleted that the Federal executive agencies will cooperate with the IRS in expeditiously obtaining clearance for the IRS employees.

This provision is effective as if included in the 1986 Act (i.e., on January 1, 1987).

7. Information reporting on royalties (sec. 6677(g) of the bill, sec. 1523 of the Reform Act, and sec. 6676 of the Code)

Present Law

Persons who make payments of royalties aggregating $10 or more to any person in a calendar year must provide an information report on the royalty payments to the IRS (as well as provide a copy to the payee) (Code sec. 6050N).

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[3] Executive Order 12356 is the currently effective Executive order prescribing a uniform system for classifying, declassifying, and safeguarding national security information (47 Federal Register 14874; April 6, 1982)

Explanation of Provision

The bill deletes the requirement that payors of royalties must exercise due diligence in obtaining the taxpayer identification numbers of payees of royalties.

This requirement is eliminated because of its interaction with the requirements of backup withholding (Code sec. 3406). Prior to the bill, a payor of royalties was required to exercise due diligence in obtaining a taxpayer identification number; otherwise the payor was subject to a penalty for failure to exercise due diligence. This was parallel to the treatment of payors of interest and dividends. Payors of interest and dividends are required to impose backup withholding if the payee does not certify that the taxpayer identification number is correct. Unlike payors of interest and dividends, payors of royalties were not permitted to impose backup withholding under these circumstances. The requirement that payors of royalties exercise due diligence in obtaining taxpayer identification numbers is consequently repealed to eliminate this nonparallel treatment of royalties. After repeal, payors of royalties are treated similarly to payors of other reportable payments subject to backup withholding (other than interest and dividend payors).

8. Estimated tax requirements for tax-exempt organizations (sec. 6677(h) of the bill, sec. 1542 of the Reform Act, and sec. 6154 of the Code)

Present Law

Present law, as amended by the 1986 Act, requires that estimated tax payments of the excise tax on the net investment income of private foundations and the tax on unrelated business income of tax-exempt organizations be made in accordance with the rules generally applicable to corporate estimated tax payments.

Explanation of Provision

The bill clarifies that the corporate estimated tax provisions (secs. 6154 and 6655) apply to all payments of estimated tax by private foundations. These provisions apply whether the private foundation is organized as a trust or as a corporation, and whether or not the foundation is tax-exempt. Thus, for example, a taxable private foundation organized as a trust will be required to make estimate tax payments of both the excise tax under section 4940(b) and any income tax under subtitle A in accordance with the rules of sections 6154 and 6655. The individual estimated tax provisions will not apply to any private foundation or tax-exempt trust.[4]

The bill further provides that in the case of a tax-exempt organization or a private foundation, the period of underpayment of estimated tax runs to the 15th day of the fifth month following the close of the taxable year (i.e., the due date of the unrelated business income tax return).

The bill also provides one additional month for the computation of estimated taxes required to be paid by these tax-exempt organizations, as well as by trusts and estates. This is done by amending the annualization rule for these entities so that each payment is computed for a period one month shorter than present law. Thus, these entities will generally have 45 days (instead of 15 days) to compute their estimated tax payments under the annualization rule. The dates the estimated tax payments are due are not altered.

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[4] *See* also section 10214(d) of the bill.

9. Awards of attorney's fees in tax cases (sec. 6677(i) of the bill, sec. 1551 of the Reform Act, and sec. 7430(c)(2)(A) of the Code)

Present Law

The prevailing party (other than the United States) in tax cases may be eligible for an award of attorney's fees if it can establish that the position of the United States was not substantially justified and if other conditions are satisfied, which are generally parallel to the requirements for an award of attorney's fees under the Equal Access to Justice Act (which generally applies in non-tax cases).

Explanation of Provision

The bill clarifies two cross-references to provisions of the Equal Access to Justice Act. First, the bill clarifies that the rules of that Act relating to the time period within which a claim for attorney's fees must be made also apply to claims in tax cases. Second, the bill clarifies that the net worth limitations of the Act (rather than parallel provisions elsewhere in the United States Code) apply to prevailing parties in tax cases.

10. Salary of special trail judges (sec. 6677(j) of the bill and sec. 1556 of the Reform Act)

Present Law

The salary of special trial judges of the Tax Court is 90 percent of the salary of judges of the Tax Court (Code sec. 7443A(d)(1)). The President's salary recommendations [5] may be construed to have reduced the salary of special trial judges below that 90-percent level.

Explanation of Provision

The bill provides that to the extent the President's salary recommendations are inconsistent with the 90-percent level specified in the Code, the recommendations are not effective.

11. Retirement pay of Tax Court judges (sec. 6677(k) of the bill, sec. 1557 of the Reform Act, and sec. 7447 of the Code)

Present Law

A Tax Court judge's retirement pay is based upon the judge's length of service as a judge. A judge who serves on the Tax Court at least 10 years receives full retirement pay, the retirement pay of a judge serving less than 10 years is proportionately reduced. Time served as a judge in recalled status after retirement does not count for purposes of computing the 10-year period.

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[5] *Budget of the United States Government, 1988, Recommendations for Executive, Legislative, and Judicial Salaries*, submitted to the Congress on January 5, 1987.

Explanation of Provision

The bill provides that service on a substantially full-time basis in recalled status after retirement is considered in computing the 10-year period. The provision applies for purposes of determining retirement pay paid after the date of enactment of the bill, regardless of when the services in recalled status after retirement were or are performed.

12. Suspension of statute of limitations during prolonged dispute over third-party records (sec. 6677(l) of the bill, sec. 1561 of the Reform Act, and sec. 7609 of the Code)

Present Law

If a dispute between a third-party recordkeeping and the IRS is not resolved within six months after the IRS issues an administrative summons, the statute of limitations is suspended until the issue is resolved (sec. 7609(e)).

Explanation of Provision

The bill clarifies that this suspension of the statute of limitations encompasses disputes with all third-party recordkeeping listed in the statute, regardless of whether the summons does or does not identify the person with respect to whose liability the summons is issued.

13. Rescission of statutory notice of deficiency (sec. 6677(m) of the bill, sec. 1562 of the Reform Act, and sec. 6212 of the Code)

Explanation of Provision

Where the IRS and the taxpayer mutually agree, a statutory notice of deficiency may be rescinded. Once the notice has been properly rescinded, it is treated as if it never existed.

Explanation of Provision

The bill clarifies that rescission of a statutory notice of deficiency does not affect any suspension of the running of any period of limitations during any period during which the rescinded notice was outstanding. For example, assume that six months remain to run on the satatute of limitations with respect to a return when the IRS issues a statutory notice of deficiency. Issuance of this notice suspends the statute of limitations. If the IRS and the taxpayer agree to rescind the statutory notice, then as of the date the notice is rescinded, the statute of limitations again begins to run and (in this example) six months remais until the statute expires.

14. Abatements of interest due to error or delay (sec. 6677(n) of the bill, sec. 1563 of the Reform Act, and sec. 6404(e)(1) of the Code)

Present Law

The IRS may, under specified conditions, abate interest that is attributable to error or delay by the IRS.

Explanation of Provision

The bill adds "error" as a condition justifying abatement to one reference where it was inadvertently omitted.

15. Modification of withholding schedules (sec. 6677 the bill and sec. 1581(c) of the Reform Act)

Present Law

If an employee did not file a revised Form W-4 before October 1, 1987, the employer must withhold income taxes as if the employee claimed one allowance (if the employee checked the "Single" box on the most recent Form W-4 that the employee filed) or two allowances (if the employee checked the "Married" box).

Explanation of Provision

The bill provides that this rule would not apply if it would result in an increase in the number of withholding allowances for an employee. This is consistent with IRS instructions to employers.

16. General requirement of return, statement, or list (sec. 6677(p) of the bill and sec. 6011 of the Code)

Present Law

When required by regulations, any person liable for any tax or the collection thereof must make a return of statement in the manner required.

Explanation of Provision

The bill clarifies the language of the Code containing this requirement.

17. Certain refundable credits to be assessed under deficiency procedures (sec. 6677(q) of the bill and sec. 6211 of the Code)

Present Law

Under present law, the deficiency procedures allowing taxpayers to litigate issues in the Tax Court relating to the earned income credit (sec. 32) and the credit for the certain payments of the gasoline and special fuels tax (sec. 34) may not apply.

Explanation of Provision

The bill provides that the Tax Court deficiency procedures apply to the credits allowable under sections 32 and 34, notwithstanding that the credits reduce the net tax to less than zero.

The provision applies to taxable years beginning after the date of enactment of the bill.

18. Exemption from levy for service-connected disability payments (sec. 6677(r) of the bill and sec. 6334 of the Code)

Present Law

Under present law, various payments, such as unemployment benefits, workers' compensation, an amount of specified ordinary wages, as well as certain pensions and annuities, are exempt from levy. Thus, the IRS cannot seize these payments to collect delinquent taxes by serving a levy on the payment source. The IRS can collect the delinquent taxes from other nonexempt sources available to the delinquent taxpayer.

Certain service-connected disability benefits are included among those payments which are exempt from levy under section 6334. The term "service-connected" means that the disability was incurred or aggravated in the line of duty in the active military, naval, or air service. This exemption covers direct compensation payments, as well as other types of support payments for education and housing.

The service-connected disability payments that presently are exempt from IRS levy include the following veterans' benefits described in Title 38, United States Code: wartime or peacetime or general compensation (subchapters II, IV, and VI of chapter 11 of title 38); certain life insurance payments (subchapters I, II, and III of chapter 19); specially adapted housing grants (chapter 21); vocational rehabilitation benefits (chapter 31); post-Vietnam era veterans' educational assistance (chapter 34); survivors' and dependents' educational assistance (chapter 35); housing and small business loans (chapter 37); and automobiles and adaptive equipment for certain disabled veterans (chapter 39).

Explanation of Provision

The bill adds the following service-connected disability benefits to those payments which, pursuant to section 6334, are exempt from levy by the IRS: compensation for wartime and peacetime death (provided for in subchapters III and V of chapter 11 of title 38, United States Code); dependency and indemnity compensation for service-connected deaths (provided for in chapter 13 of title 38, United States Code); and certain burial benefits (provided for in chapter 23 of title 38, United States Code). The bill revokes the present-law exemption from IRS levy for certain life insurance payments (provided for by chapter 19 of title 38, United States Code).

XVI. Exempt and Nonprofit Organizations (Sec. 6678 of the bill)

1. Title-holding companies (sec. 6678 of the bill, secs. 1603 and 1878(e) of the Reform Act, and secs. 501(c)(25) and 514(c)(9) of the Code)

Present Law

In general

The Act provides a new category of tax-exempt organizations, consisting of certain corporations or trusts that are organized for the exclusive purposes of acquiring and holding title to real property, collecting income from such property, and remitting the income (less expenses) from such property to one or more specified categories of tax-exempt organizations that are shareholders of the corporation or beneficiaries of the trust (Code sec. 501(c)(25)). Such a title-holding company is entitled to tax-exempt status only if it has more than 35 shareholders or beneficiaries and has only one class of stock or beneficial interest, and only if it meets certain other requirements.

Eligible shareholders or beneficiaries

Under the Act, the categories of tax-exempt organizations eligible to hold interests in a section 501(c)(25) title-holding company are (1) a qualified pension, profit-sharing, or stock bonus plan (sec. 401(a)); (2) a governmental pension plan (sec. 414(d)); (3) the United States, a State or political subdivision or governmental agencies or instrumentalities; (4) tax-exempt charitable, educational, religious, or other organizations described in section 501(c)(3); and (5) other title-holding companies described in section 501(c)(25).

Rights of eligible shareholders or beneficiaries

To qualify under section 501(c)(25), the title-holding company is required to permit its shareholders or beneficiaries to (1) dismiss, after reasonable notice, the corporation's or trust's investment advisor by majority vote of the shareholders or beneficiaries; and (2) terminate their interest by (a) selling or exchanging their stock or beneficial interest (subject to Federal or state securities law) to any other eligible organization, as long as the sale of exchange does not increase the total number of shareholders or beneficiaries to more than 35, or (b) redeeming their stock or beneficial interest after providing 90 days' notice to the corporation or trust. The Act did not expressly provide a sanction for the failure of a title-holding company to satisfy the requirements relating to the rights of eligible shareholders or beneficiaries.

Unrelated business taxable income

Exempt organizations are subject to tax on any unrelated business taxable income, including income from debt-financed property. (An organization is not precluded from qualifying for tax-exempt status merely because it derives unrelated business taxable income, so long as the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business.) The term debt-financed property means any property held to produce income with respect to which there is acquisition indebtedness at any time during the taxable year, or during the 12 months prior to disposition if the property is disposed of during the taxable year (sec. 514(b)).

Under an exception to the debt-financed property rules, indebtedness incurred by certain tax-exempt organizations (i.e., qualified pension plans and certain tax-exempt educational organizations) as a result of the acquisition or improvement of real property is not considered acquisition indebtedness (sec. 514(c)(9)). The Act extended this exception to debt-financed real property held by a section 501(c)(25) title-holding company.

The Act also provides that an interest in a mortgage is not treated as an interest in real property for purposes of the debt-financed property rules in the case of real property held by a partnership (sec. 514(c)(9)(B)(vi)).

Explanation of Provision

Definition of real property

The bill clarifies the definition of permissible holdings of real property by a title-holding company by providing that, for purposes of section 501(c)(25), the term real property does not include any interest as a tenant in common (or similar interest) and does not include any indirect interest. This rule ensures a consistent application of the intent of section 501(c)(25) that a title-holding company is required to hold real property directly and cannot, for example, treat an interest in a partnership, trust, or other entity as an investment in real property.

The bill also provides that for purposes of section 501(c)(25), the term real property includes any personal property that is leased under, or in connection with, a lease of real property. This exception to the general rule that a section 501(c)(25) title-holding company may only hold real property applies only if the rent attributable to the leasing of such personal property (determined under the rules of sec. 856(d)(1)) for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property under the lease.

Eligible shareholders or beneficiaries

In order to implement the 35-person limitation on shareholders or beneficiaries of a section 501(c)(25) organization, the bill deletes the provision of the Act that had defined an eligible shareholder or beneficiary in a title-holding company to include other section 501(c)(25) title-holding companies. In lieu of that rule, the bill provides that a corporation that is a qualified subsidiary of a section

501(c)(25) title-holding company is not to be treated as a separate corporation for Federal tax law purposes. In the case of such a qualified subsidiary, all assets, liabilities, and items of income, deduction, and credit of the qualified subsidiary are treated as assets, liabilities, and such items of the title-holding company.

Under the bill, the term qualified subsidiary means a corporation that, at all times while in existence, is wholly owned by the section 501(c)(25) title-holding company. If a qualified subsidiary subsequently ceases to satisfy the 100-percent stock ownership requirement, the qualified subsidiary is treated, immediately before the time it ceases to meet such ownership requirement, as a new corporation acquiring all of its assets and assuming all of its liabilities in exchange for its stock.

Rights of shareholders or beneficiaries

The bill expressly provides that a title-holding company is not entitled to tax-exempt status under section 501(c)(25) if it fails to permit its shareholders or beneficiaries to dismiss the organization's investment advisor or to terminate their interest in the corporation or trust in the manner specified in the statute.

Unrelated business taxable income

The bill modifies the exception to the unrelated business taxable income rules in the case of debt-financed real property owned by a section 501(c)(25) title-holding company to provide that the exception is not available in the case of a disqualified holder. (Of course, a title-holding company does not fail to qualify for tax-exempt status merely because its shareholders or beneficiaries have unrelated business income as a result of the operation of this rule.)

Thus, in computing the unrelated business taxable income of a disqualified holder of an interest in a title-holding company, the holder's pro rata share of the items of income that are treated as gross income derived from an unrelated trade or business (without regard to the exception for debt-financed real property) is taken into account as gross income of the disqualified holder derived from an unrelated trade or business. Further, the holder's pro rata share of the items of deductions allowable in computing unrelated business taxable income (without regard to the exception for debt-financed real property) also is taken into account as deductions in computing unrelated business taxable income. These items of income and deduction are taken into account for the taxable year of the holder in which (or with which) the taxable year of the title-holding company ends.

Under the bill, the term disqualified holder means any title-holding company shareholder or beneficiary other than either (1) an educational institution (described in sec. 170(b)(1)(A)(ii)) or its affiliated support organizations (described in sec. 509(a)(3)) or (2) a qualified pension trust (within the meaning of sec. 401(a)).

Under the bill, the rule excluding an interest in a mortgage from the definition of real property applies for all purposes under the exception for debt-financed real property, rather than solely in the case of real property held by a partnership.

XVII. Miscellaneous Provisions (Sec. 6679 of the bill)

1. Tax-exempt entity leasing; definition of tax-exempt controlled entity (sec. 6679(b)(2) of the bill, sec. 1802(a)(2) of the Reform Act, and sec. 168(h) of the Code)

Present Law

Under the Act, the term "tax-exempt controlled entity" does not include a corporation more than 50 percent of the stock in which is owned by a foreign person or entity. In addition, in the case of a corporation the stock of which is publicly traded, a tax-exempt entity's holdings are disregarded unless such entity owns at least five percent of the stock in the corporation (sec. 168(h)(6)(F)(iii)).

Explanation of Provision

The bill clarifies that the amendment applies as if enacted in the Tax Reform act of 1984.

2. Accrual of interest on certian short-term obligations (sec. 6679(c) of the bill, sec. 1803(a)(8) of the Reform Act, and sec. 1281 of the Code)

Present Law

Under section 1281 of the Code, certain taxpayers are required to include in income as interest for taxable year that portion of the acquisition discount or original issue discount on a short-term obligation that is allocable to the portion of the year during which the taxpayer held the obligation. The Act clarified that taxpayers subject to the rule for mandatory accrual are required to include in income for a taxable year all amounts of interest, irrespective of whether the interest is stated or is in the form of discount. The amendment made by the Act applies to obligations acquired after September 27, 1985.

Explanation of Provision

The bill provides that the amendment made by the Act applies only to obligations acquired after December 31, 1985. It is understood that many of the taxpayers affected by the amendment made by the Act are small banks that, as a group, customarily file returns without extension. It is also understood that small banks may not have the capacity to develop the required information for both 1985 and 1986, in time for banks to file their 1986 returns without extensions. The purpose of the change in effective date is to relieve these taxpayers of the administrative burden of identifying stated interest on short-term obligations acquired after September 27, 1985 and before January 1, 1986. For obligations acquired after December 31, 1985, taxpayers will be required to comply with the amendment made by the Act.

3. Earnings and profits (sec. 6679(d)(3) of the bill, sec. 1804 of the Reform Act, and sec. 312(b) of the Code)

Present Law

The Act clarified the effect on earnings and profits of a distribution of appreciated property.

Explanation of Provision

The bill provides that the rules relating to the distribution of appreciated property under section 312(b) do not apply to a distribution of a corporation's own obligation. Thus, earnings and profits will not be increased by reason of such a distribution.

4. Treatment of transferor corporation (sec. 6679(d)(5) of the bill, sec. 1804 of the reform Act, and secs. 361 and 355 of the Code)

Present Law

The Tax Reform Act of 1984 generally required that all property received by a corporation in a "C" reorganization be distributed. In addition, that Act provided that a corporation must be recognized gain on the distribution of appreciated property to its shareholders in a nonliquidating distribution. The 1986 Act made a series of amendments to the reorganization provisions attempting to conform those provisions with changes made by the 1984 Act. However, numerous technical problems with the 1986 amendments have arisen, The bill responds to these technical problems with a complete revision of the 1986 amendments.

Explanation of Provision

Treatment of reorganization exchange.—The bill restores the provisions of section 361, relating to the nonrecognition treatment of an exchange pursuant to a plan of reorganization, as in effect prior to the amendments made by the 1986 Act. Thus, as under prior law, gain or loss will generally not be recognized to a corporation which exchanges property, in pursuance of the plan of reorganization, for stock and securities in another corporation a party to the reorganization. However, as under prior law, gain will be recognized to the extent the corporation receives property other than such stock or securities and does not distribute such other property pursuant to the plan of reorganization.[1]

The bill amends prior law by providing that transfers of property to creditors in satisfaction of the corporation's indebtedness in connection with the reorganization are treated as distributions pursuant to the plan of reorganization for this purpose.[2] The Secretary of the Treasury may prescribe regulations necessary to prevent tax avoidance by reason of this provision. This amendment is not intended to change in any way the definition of a reorganization within the meaning of section 368.

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[1] This could occur, for example, where liabilities are assumed in a transaction to which section 357(b) or (c) applies.

[2] This overrules the holding in *Minnesota Tea Company* v. *Helvering*, 302 U.S. 609 (1938).

Treatment of distributions in reorganizations.—The bill also conforms the treatments of distributions of property by a corporation to its shareholders in pursuance of a plan of reorganization to the treatment of nonliquidating distributions (under section 311). Under the bill, the distributing corporation generally will recognize gain, but not loss, n the distributing of property in pursuance of the plan of reorganization. However, no gain will be recognized on the distribution of "qualified property". For this purpose, "qualified property" means (1) stock (or rights to acquire stock) in, or the obligation of, the distributing corporation and (2) stock (or rights to acquire stock) in, or the obligation of, another corporation which is a party to the reorganization and which were received by the distributing corporation in the exchange [3]. The bill also provides that the transfer of qualified property by a corporation to its creditors in satisfaction of indebtedness is treated as a distribution pursuant to the plan of reorganization.[4]

Basis.—The bill clarifies that the basis of property received in a exchange to which section 361 applies, other than stock or securities in another corporation a party to the reorganization, is the fair market value of the property at the time of the transaction (pursuant to section 358(a)(2)). Thus, the distributing corporation will recognize only post-acquisition gain on any taxable disposition of such property received pursuant to the plan of reorganization. Of course, the other corporation will recognize gain or loss on the transfer of its property under the usual tax principles governing the recognition of gain or loss.

Treatment of section 355 distributions.—Finally, the bill provides that the rules of section 311 shall apply to the distribution of property in a section 355 transaction which is not in pursuance to a plan of reorganization. Thus, gain (but not loss) will be recognized on the distribution of property other than the stock or securities in the controlled corporation in a transfer to which section 355 (or so much of section 356 as relates to section 355) applies. For this purpose, the gain recognition provisions of section 311(b) will not apply to the distribution of securities notwithstanding that the recipient may be taxed by reason of the excess principal amount rule of section 355(a)(3)(A), but the gain recognition rule will apply to stock which is not permitted to be received tax-free under section 355(a).

5. Golden parachutes (sec. 6679(d)(6)-(8) of the bill, sec. 1804(j) of the Reform Act, and sec. 280G of the Code)

Present Law

Under present law, no deduction is allowed for "excess parachute payments" (sec. 280G) and a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment (sec. 4999).

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[3] For analysis that acquiring corporation voting stock held by the acquired corporation in a Type C reorganization is transferred to the acquiring corporation in exchange for the same stock, see Rev. Rul. 78-47, 1978-1 C.B. 113.

[4] These amendments are not intended to affect the treatment of any income from the discharge of indebtedness arising in connection with a corporate reorganization.

The term parachute payment does not include any payment made to (or for the benefit of) a disqualified individual (1) with respect to a corporation that was, immediately before the change in control, a small business corporation (as defined in sec. 1361(b), relating to S corporations) or (2) with respect to a corporation no stock of which was, immediately before the change in control, readily tradable on and established securities market, or otherwise, provided shareholder approval was obtained with respect to the payment to a disqualified individual.

The Secretary may, by regulations, provided that a corporation fails to meet the requirement that it have no stock that is readily tradable if a substantial portion of the assets of any entity consists (either directly or indirectly) of stock in the corporation and interests in the entity are readily tradable on an established securities market, or otherwise.

Congress was concerned that, absent specific rules, a taxpayer might utilize the exemption for shareholder approval to avoid the golden parachute provisions by creating tiers of entities. Such avoidance is possible if the gross value of the entity-shareholder's interest in the corporation constitutes a substantial portion of such entity's assets. Congress contemplated that, in such cases, the Secretary will adopt regulations requiring approval of the owners of the entity rather than the approval of the entity itself. Of course, such shareholder approval may be obtained only if the entity shareholder also has no stock that is readily tradable.

The Secretary is authorized to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the golden parachute provisions.

Explanation of Provision

Under present law, a corporation could fail to qualify for the shareholder approval exception if it has nonvoting preferred stock that is publicly traded, even if all common stock of the corporation is not publicly traded. In some cases, an interest in preferred stock is more in the nature of debt than equity. The purpose of the golden parachute provisions is to protect equity shareholders whose interest in the corporation could be impaired by parachute payments to disqualified individuals. No protection is necessary in the case of nonvoting preferred stock if the preferred shareholders receive the redemption or liquidation value to which they are entitled.

Thus, the bill provides that, for purposes of the shareholder approval requirements, the term "stock" does not include any stock (1) that is not entitled to vote, (2) that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, (3) that has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium) (4) that is not convertible into another class of stock, and (5) the rights of which are not adversely affected by the parachute payments.

The bill addresses several issues that arise in the application of the shareholder approval requirements for a corporation the stock of which is not publicly traded by expanding the Secretary's regulatory authority under the golden parachute provisions. It is expected that regulations will address these issues, particularly the application of the shareholder approval requirements in the case of shareholders that are not individuals (i.e., the shareholders are partnerships, corporations, or other nonindividual entities), and to what extent nonvoting interests in the entity shareholder have the right to affect the approval of that shareholder. In general, it is anticipated that the normal voting rights of the entity shareholder will determine whether or not the entity shareholder approves the parachute payments. For example, limited partners with no right to vote on partnership issues generally would not be entitled to vote with respect to the partnership shareholder's approval of a parachute payment.

The bill specifically authorizes the Secretary to prescribe regulations addressing the application of the shareholder approval requirements to entity shareholders that hold de minimis amounts of stock in the corporation. Of course, shareholder approval would still be required if the corporation constituted a substantial portion of the assets of the entity shareholder.

For purposes of the small business exception, the bill provides that "small business corporation" is defined as in section 1361(b) but without regard to paragraph (1)(C) thereof (relating to nonresident aliens). In the golden parachute context, the effect of the use of the small business corporation definition was to treat domestic corporations less favorably to the extent they were owned by foreign persons rather than U.S. persons. Because less favorable treatment was accorded to these corporations solely because they were owned by foreign persons (as contrasted to U.S. corporations whose shareholders were not taxable by the United States), this golden parachute provision descriminated against foreign persons and would have violated certain U.S. treaties.

6. Settlement funds (sec. 6679(f) of the bill, sec. 1807(a)(7) of the Reform Act, and sec. 468B of the Code)

Present Law

A taxpayer generally may deduct qualified payments to a designated settlement fund at the time such payments are made. A qualified payment does not include any amount which may be transferred from a designated settlement fund to the taxpayer. The taxpayer may not hold a beneficial interest in the income or corpus of the fund.

Under the Act, the income earned on amounts transferred to an escrow account, settlement fund, or other similar fund is subject to current tax notwithstanding any other provision of law. The Act also provides that if the amount transferred to an account or fund is not deductible, then the account or fund is taxed as a grantor trust.

Explanation of Provision

The bill clarifies that a qualified payment does not include any amount which may be transferred from a designated settlement fund to any person related to the taxpayer.

The bill also clarifies that a designated settlement fund (1) must extinguish completely the taxpayer's tort liability with respect to a class of claimants, and (2) must not under its terms provide a beneficial interest in the income or corpus of the fund to any person related to the taxpayer.

The bill incorporates as part of the Code the provision of the Act relating to the current taxation of the income earned by amounts transferred to an escrow account, settlement fund, or other similar fund. The bill also authorizes the Secretary to prescribe regulations that identify the person that is subject to current tax on the income from an account or fund.

It is anticipated that these regulations will provide that if the amount is transferred pursuant to an arrangement that constitutes a trust, then the income earned by the amounts transferred will be currently taxes under Subchapter J of the Code. Thus, for example, if the transferor retains a reversionary interest in any portion of the trust that exceeds 5 percent of the value of that portion, or the income of the trust may be paid to the transferor or may be used to discharge a legal obligation of the transferor then the income is currently taxable to the transferor under the grantor trust rules.

7. Certain transfers of incentive stock options (sec. 6679(k) of the bill, sec. 1842 of the Reform Act, and sec. 425(c) of the Code)

Present Law

The 1984 Act provided that transfers of property between spouses or incident to divorce were non-taxable carry-over basis transactions.

Explanation of Provision

The bill clarifies that the transfer of stock acquired pursuant to the exercise of an incentive stock option between spouses or incident to divorce is tax-free.

8. Treatment of stripped tax-exempt bonds (sec. 6679(p)(4) of the bill, sec. 1879 of the Reform Act, and sec. 1286(d) of the Code)

Present Law

In determining the basis of a stripped coupon or stipped bond relating to a tax-exempt obligation under present law, the holder makes adjustments to basis to account for the accrual of original issue discount ("OID"). The total adjustment to basis on account of OID is an amount not in excess of that amount which produces a yield to maturity equal to the lower of (1) the coupon rate on the tax-exampt obligation, or (2) the yield to maturity of the stripped coupon or stripped bond.

Explanation of Provision

Under the bill, in the case of a tax-exempt obligation from which one or more coupons have been stripped, a portion of OID with respect to any stripped coupon or stripped bond (as determined under the general coupon stripping rules) is treated as OID on a tax-exempt obligation. OID in excess of the "tax-exempt portion" is treated as OID on an obligation that is not a tax-exempt obligation.

Under the bill, the tax-exempt portion of the OID with respect to a stripped coupon or stripped bond relating to a tax-exempt obligation is the excess of the stated redemption price at maturity (or in the case of a coupon, the amount payable on the due date of the coupon), over an issue price that would produce a yield to maturity as of the purchase date (of the stripped coupon or stripped bond) equal to the lower of (1) the coupon rate on the tax-exempt obligation from which the coupons were separated, or (2) the yield to maturity (on the basis of the purchase price) of the stripped coupon or stripped bond. The taxpayer can elect to use the original yield to maturity instead of the coupon rate for these purposes.

For example, assume that a tax-exempt obligation with a face amount of $100 due January 1, 1990, and with a coupon rate of 10 percent (compounded semiannually) is issued for $100 on January 1, 1987, and is stripped on January 1, 1989. The right to receive the principal amount is sold for $79.21 reflecting a yield to maturity at the time of the strip of 12 percent (compounded semiannually). Under the bill, the tax-exempt portion of discount on the stripped bond is limited to $17.73, the difference between the stated redemption price ($100) and the issue price that would produce a yield to maturity of 10 percent ($82.27). This portion of the discount is treated as OID on a tax-exempt obligation.

The amount of discount on the stripper bond in excess of the tax-exempt portion is $3.06, equal to the excess of total discount ($20.79) over the tax-exempt portion. This portion of the discount is treated as OID with respect to an obligation that is not a tax-exempt obligation.

The total amount of OID allocable to the accrued period ending on July 1, 1988, with respect to the stripped-bond is $4.75 (6 percent of $79.21), of which $4.11 is treated as OID on a tax-exempt obligation (5 percent of $82.27) and $0.64 ($4.75 minus $4.11) is treated as OID on an obligation that is not a tax-exempt obligation. The holder's basis for the bond is increased to $83.96 ($79.21 issue price plus accrued discount of $4.75).

The provision is effective for any purchase or sale of a stripped coupon or stripped bond relating to a tax-exempt obligation after June 10, 1987. Present law remains in effect for any purchase or sale of any such stripped coupon or bond after October 21, 1986, and before June 11, 1987. Present law also remains in effect in the case of any person who, on June 10, 1987, held for sale in the ordinary course of such person's trade or business any obligation or coupon in stripped form, with respect to any sale of such obligation or coupon by such person, and with respect to any such obligation or coupon while held by another person who purchased such obligation from the person who held such obligation or coupon on June 10, 1987.

9. Reorganizations of investment companies (sec. 6679(p)(5) of the bill, sec. 1879 of the Reform Act, and sec. 368 of the Code)

Present Law

The Act provided that stock of a RIC, REIT, or diversified investment company will not be treated as stock of a single issuer for purposes of determining whether the holder is diversified within the meaning of section 368(a)(2)(F)(ii). The legislative history of that amendment provided that the provision was intended to permit an investment company to be treated as a diversified investment company only if it would be so defined if it were deemed to own its ratable share of the assets of any RIC, REIT, or diversified investment company in which it owns stock (without regard to whether its percentage ownership is 50 percent or more).

Explanation of Provision

The bill conforms the statutory language to the legislative history of the Act. The bill provides that, for purposes of determining whether a corporation is diversified, a person holding stock in a RIC, REIT, or diversified investment company shall, except as otherwise provided in regulations, be treated as holding its proportionate share of the assets held by the RIC, REIT, or diversified investment company. It is anticipated, for example, that the regulations may provide for exceptions in de minimis cases.

10. Elimination of duplicative Medicare tax provisions for certain State and local government employees (sec. 6679(q) of the bill, sec. 1895 of the Reform Act, and sec. 3121(u) of the Code)

Present Law

Under Code section 1402(c), certain employees of State or local governments who are compensated solely on a fee basis are subject to the self-employment (SECA) tax, including the Medicare portion of that tax. The Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272) extended Medicare coverage and tax to State and local government employees hired after 1985, effective for service performed after March 31, 1986 (Code sec. 3121(u)). No exception was provided for certain State and local government employees who were already subject to Medicare tax under section 1402(c).

Explanation of Provision

The bill provides an exception to the Medicare tax provision in Code section 3121(u) for individuals holding a position described in section 1402(c)(2)(E), effective for services performed after March 31, 1986.

11. Application of market discount rules in case of partial principal payments (sec. 6679 of the bill, sec. 1803 of the Act, and sec. 1276 and 1278 of the Code)

Present Law

The 1984 Act provided that any partial principal payment on a market discount bond is includible in gross income to the extent that such payment does not exceed the accrued market discount on such bond.

Market discount is the excess of the stated redemption price of the bond at maturity over the basis of such bond immediately after its acquisition by the taxpayer. In the case of a bond having original issue discount, the stated redemption price at maturity is treated as equal to its revised issue price. Revised issue price is the sum of the issue price of the bond and the aggregate amount of the original issue includible in the gross income of all holders for periods before the acquisition of the bond by the taxpayer. Neither stated redemption price at maturity nor revised issue price are adjusted for partial principal payments prior to the acquisition of the bond.

Explanation of Provision

The bill clarifies that the Treasury is authorized to issue regualtions providing proper adjustment in the amount of market discount to account for partial principal payments received by prior holders of the bond.

12. Treatment of multiple trusts for taxable years beginning in 1985 (sec. 6679 of the bill, sec. 1806(a) of the Act, and sec. 643 of the Code)

Present Law

The 1984 Act provides that under Treasury regulations, two or more trusts will be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts is the avoidance of Federal income tax.

The 1984 Act makes this provision effective for taxable years beginning after March 1, 1984. The 1986 Act provides that this provision is not applicable to any trust which was irrevocable on March 1, 1984, except to the extent corpus is transferred to the trust after that date.

Explanation of Provision

The bill provides that if on a return for a taxable year beginning in 1985, two or more trusts were treated as a single trust, and they would have been required to be so treated but for the Amendment made by the 1986 Act, then such trusts will be treated as one trust for purposes of that taxable year. This provision applies only to trusts which did not accumulate any income or make any accumulation distributions during that year.

XVIII. Other Technicals: To Title XVIII of the Tax Reform Act of 1986

Treatment of multiple trusts for taxable years beginning in 1985 (sec. 6680 of the bill, sec. 1806(a) of the Act, and sec. 643 of the Code)

Present Law

The 1984 Act provides that under Treasury regulations, two or more trusts will be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts is the avoidance of Federal income tax.

The 1984 Act makes this provision effective for taxable years beginning after March 1, 1984. The 1986 Act provides that this provision is not applicable to any trust which was irrevocable on March 1, 1984 except to the extent corpus is transferred to the trust after that date.

Explanation of Provision

The bill provides that if on a return for a taxable year beginning in 1985, two or more trusts were treated as a single trust, and they would have been required to be so treated but for the Amendment made by the 1986 Act, then such trusts will be treated as one trust for purposes of that taxable years. This provision applies only to trusts which did not accumulate any income or make any accumulation distributions during that year.

TECHNICAL CORRECTIONS TO OTHER TAX LEGISLATION

A. The Superfund Revenue Act of 1986 (Sec. 6685 of the Bill)

1. Tax on chemical feedstocks (sec. 6685(a) of the bill, sec. 513 of the Superfund Act, and sec. 4662 of the Code)

Present Law

Under present law, tax is imposed on the sale (by the manufacturer, producer, or importer) of 42 organic and inorganic chemical feedstocks. If the manufacturer, producer, or importer of a taxable chemical feedstock uses the feedstock, then tax is imposed on the use of the feedstock in the same manner as if the feedstock had been sold.

Under the "mixed stream" rule, no tax is imposed on the sale or use of any taxable organic chemical while such chemical is part of an intermediate hydrocarbon stream containing a mixture of taxable organic chemicals. Where tax is not imposed by reason of the mixed stream rule, the subsequent isolation, extraction, or removal of a taxable chemical from an intermediate hydrocarbon stream is treated as a taxable use.

A credit or refund (without interest) may be allowed or made to the taxpayer for tax paid with respect to a taxable chemical feedstock which is (1) exported, or (2) used to make a listed taxable substance which is exported. No credit or refund is allowed unless the person who paid the tax either has agreed to repay the tax to the exporter, or has obtained the written consent of the exporter waiving such repayment.

Explanation of Provisions

Refunds directly to exporter

Under the bill, the Secretary is required to issue regulations providing the conditions under which credit or refund (without interest) may be allowed or made to the exporter of a taxable chemical or listed taxable substance, rather than to the person who paid the tax, where the taxpayer waives his right to receive the refund and the exporter provides such information as may be required by the Secretary. Such conditions may include (1) a requirement that the exporter and the person who paid the tax register with the Internal Revenue Service, (2) a requirement that the exporter provide written evidence that the taxpayer has waived its right to the refund, and (3) the time, place, and manner in which claims for refund or credit are to be made.

Mixed stream rule

The bill clarifies that the present law treatment of intermediate hydrocarbon streams applies where the stream contains one or more taxable organic chemical feedstocks and one or more nontaxable organic chemicals. Thus the mixed stream rule is not limited to mixtures containing two or more taxable organic chemical feedstocks. The term "intermediate hydrocarbon stream" generally means a mixture of organic chemicals which is subject to further distillation or processing in the manufacture of a taxable chemical.

2. Tax on certain imported substances (sec. 6685(b) of the bill, sec. 515 of the Superfund Act, and sec. 4672 of the Code)

Present Law

A tax is imposed on any taxable substance sold or used by the importer thereof after 1988. The amount of tax generally is equal to the tax which would have been imposed by the chemical feedstock tax (sec. 4661) on the chemicals used as materials in the manufacture of a taxable substance had such chemicals been sold in the United States.

Taxable substances are those contained in the initial list of taxable substances as modified by the Secretary. Substances are to be added to the list if the Secretary determines that taxable chemicals constitute more than 50 percent of the weight of the materials used to produce such substance (determined on the basis of the predominant method of production). The Secretary has the authority to add or remove substances from the list as necessary to carry out the purposes of the Superfund chemical tax.

Explanation of Provision

Four chemicals are added to the initial list of taxable substances: (1) Polyester (polyethylene terepthalate), (2) Nylon 66, (3) polyacrylonitrile, and (4) Nylon 6.

3. Broadbase environmental tax (sec. 6685(c) of the bill, sec. 516 of the Superfund Act, and secs. 59A and 882 of the Code)

Present Law

Under present law, an environmental tax is imposed on corporations equal to 0.12 percent on the excess of modified alternative minimum taxable income ("AMTI") for the taxable year over $2 million. Modified AMTI means AMTI as defined for purposes of the corporate alternative minimum tax without regard to the alternative net operating loss and environmental tax deductions.

Although regulated investment corporations ("RICs") and real estate investment trusts ("REITs") are passive investment entities, they are classified as corporations and may have corporate alternative minimum taxable income.

Explanation of Provisions

RICs and REITs

The bill clarifies that the environmental tax does not apply to RICs and REITs.

Foreign corporations

The bill clarifies that a foreign corporation engaged in a trade or business within the United States is subject to the environmental tax on its income which is effectively connected with the conduct of a trade or business within the United States.

4. Leaking Underground Storage Tank Trust Fund tax (sec. 6685(d) of the bill, sec. 521 of the Superfund Act, and secs. 4041, 4042, and 4081 of the Code)

Present Law

Under present law, an additional 0.1 cent per gallon tax is imposed on gasoline, diesel, special motor fuels, and other liquid fuels that are otherwise subject to fuels excise taxes. This tax also is imposed on any liquid used, or sold for use, as a fuel in a diesel-powered train. Revenues from this tax are used to finance the Leaking Underground Storage Tank ("LUST) Trust Fund. The additional tax generally is imposed on the same tax base and is collected in the same manner as the other excise taxes on these fuels (Code secs. 4041, 4042, and 4081). The tax is not imposed on liquified petroleum gas.

Explanation of Provisions

Tax on diesel fuel may be imposed on sale to retailer

The bill clarifies that the 0.1 cent per gallon LUST tax on diesel fuel is imposed upon sale to a qualified retailer in situations where the tax on diesel fuel for highway vehicle use is imposed on such sale.

Liquids used in aviation

The bill clarifies that the 0.1 cent per gallon LUST tax applies to all liquids used, or sold for use, as fuel in an aircraft, but that the LUST tax is not to be imposed twice (i.e., by reason of both sections 4041 and 4081). The bill also clarifies that the additional tax imposed by section 4041(c) on gasoline used as a fuel in noncommercial aviation is computed without regard to the LUST tax, and thus is not reduced by the LUST tax.

Exempt sales

The bill clarifies that gasoline which is used as a fuel in an aircraft or in a train is not exempt from the LUST tax by reason of section 6421 (relating to off-highway business use and sales of gasoline for certain other exempt purposes).

Floor stock tax

The bill clarifies that certain gasoline which on January 1, 1988 is held by a dealer is to be subject to a floor stocks tax at a rate of 9.1 cents rather than 9 cents per gallon. This ensures that the 0.1 cent per gallon LUST tax is collected on such gasoline. The revenue attributable to the additional floor stock tax is to be transferred to the Leaking Underground Storage Tank Trust Fund. The bill further clarifies that the penalty and other provisions of law applicable to section 4081 taxes also apply to the floor stock tax.

B. The Harbor Maintenance Revenue Act of 1986 (Sec. 6686 of the Bill)

1. Tax rate for fuel used on inland waterways (sec. 6686(a) of the bill, sec. 1404(a) of the Harbor Revenue Act and sec. 4042(b) of the Code)

Present Law

The Superfund Revenue Act of 1986 (P.L. 99-499), as enacted on October 17, 1986, imposed an additional separate "Leaking Underground Storage Tank Trust Fund financing rate"of 0.1 cent per gallon on fuel subject to the existing inland waterways fuel tax (Code sec. 4042). The Harbor Maintenance Revenue Act of 1986 (P.L. 99-662), enacted on November 17, 1986, amended section 4042 to provide a gradual increase in the rate of waterways fuel tax, the revenues from which are transferred to the Inland Waterways Trust Fund. In restating the increased tax rates in section 4042(b), this subsequent amendment failed to include the 0.1 cent per gallon additional tax rate (for the Leaking Underground Storage Tank Trust Fund) that had been enacted the previous month.

Explanation of Provision

The bill provides that for purposes of Code section 4042 (inland waterways fuel tax), the amendment made by the Superfund Revenue Act of 1986 relating to the separate 0.1 cent per gallon tax for the Leaking Underground Storage Tank Trust Fund is to be treated as enacted after the amendment to section 4042 made by the Harbor Maintenance Revenue Act of 1986.

The bill therefore reinstates the separate 0.1 per gallon tax rate (in sec. 4042) for the Leaking Underground Storage Tank Fund, as if included in the Harbor Maintenance Revenue Act of 1986. Thus, the additional 0.1 cent per gallon fuel tax is effective as of January 1, 1987, i.e., the effective date for such tax as enacted in the Superfund Revenue Act.

2. Exemption from the harbor maintenance tax for cargo transported between U.S. possessions, etc. (sec. 6686(b) of the bill, sec. 1402 of the Harbor Revenue Act, and sec. 4462(b) of the Code)

Present Law

A new harbor maintenance tax (Code secs. 4461-4462) was imposed under the Harbor Maintenance Revenue Act of 1986 (P.L. 99-662), effective April 1, 1987. The tax is 0.04 percent of the value of commercial cargo loaded or unloaded at U.S. ports.

Under section 4462(b), the tax does not apply to (1) cargo loaded on a vessel in a U.S. mainland port for transportation to Alaska, Hawaii, or a U.S. possession for ultimate use or consumption therein; (2) cargo loaded on a vessel in Alaska, Hawaii, or a U.S. possession for transportation to the U.S. mainland for ultimate use or consumption therein; (3) unloading of such cargo (described in (1) or (2), above)) in Alaska, Hawaii, or any U.S. possession or in the U.S. mainland, respectively; or (4) cargo loaded on a vessel in Alaska, Hawaii, or a U.S. possession and unloaded in the State or possession in which loaded. The exception does not apply to crude oil cargo with respect to Alaska.

Explanation of Provision

The bill provides a specific exemption in section 4462(b)(1)(B) for cargo transported between U.S. possessions, between U.S. possessions and Alaska or Hawaii, and between Alaska and Hawaii. The amendment is effective as if included in the Harbor Maintenance Act of 1986 (i.e., of July, 1987).

3. Due date for study of impact of harbor maintenance tax on potential cargo diversion (sec. 6686(c) of the bill and sec. 1407 of the Harbor Revenue Act)

Present Law

Under the Harbor Maintenance Revenue Act of 1986, the Secretary of the Treasury (in consultation with the Secretaries of the Army and Transportation, the U.S. Trade Representative, and other appropriate Federal agencies) is to conduct a study to determine the impact of the harbor maintenance tax (0.04 percent of the value of the commercial cargo) on potential diversions of cargo to Canada or Mexico from U.S. ports. The report is due to the Congress by November 17, 1987 (one year after the date of enactment).

Explanation of Provision

The bill extends the due date for the cargo diversion study until April 1, 1988.

C. The Omnibus Budget Reconciliation Act of 1986 (Sec. 6687 of the Bill)

1. Exclusion of discharge of indebtedness income in determining tax-exempt status of mutual or cooperative telephone and electric companies (sec. 6687 (a) of the bill, sec. 1011(a) of the Omnibus Budget Reconciliation Act of 1986, sec. 623 of Public Law 99-591, and sec. 512(c)(12)(A) of the Code)

Present Law

Under present law, benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations are exempt Federal income tax (other than on unrelated business taxable income) so long as amounts collected from members for the sole purpose of meeting losses and expenses (Code sec. 501(c)(12)). In the case of mutual or cooperative telephone companies, the 85-percent test is determined without regard to income received or accured from (1) nonmember telephone companies for the performance of communication services with members, (2) certain pole rentals, and (3) the sale of display listing in a directory furnished to members. In the case of mutual or cooperative electric companies, the 85-percent test is determined without regard to income received or accured from certain pole rentals.

Also under present law, gross income includes "income from discharge of indebtedness" (sec. 61(a)(12)). A discharge of indebtedness is considered to occur whenever a taxpayer's debt is forgiven, cancelled, or otherwise discharged by a payment of less than the principal amount of the debt. The amount of the indebtedness discharged is equal to the difference between the face amount of the debt, adjusted for any unamortized premium or discount, and any consideration given by the taxpayer to effect the discharge.

Section 1011(a) of the Omnibus Budget Reconciliation Act of 1986 and section 623 of Public Law 99-591 provided that certain loans made pursuant to sections 306A, 306B, or 311 of the Rural Electrification Act of 1936 could be prepaid at an amount less than the principal amount of the debt.

Explanation of Provision

The bill provides that, in the case of mutual or cooperative telephone companies or electric companies, the 85-percent test of section 501(c)(12) is to be determined without regard to any income from discharge of indebtedness arising from the prepayment of a loan under section 306A, 306B, or 311 of the Rural Electrification Act of 1936, as in effect of January 1, 1987.

2. Payment period for excise taxes on imported beverages and tobacco products (sec. 6687)(b) of the bill, sec. 8011 of the Omnibus Budget Reconciliation Act of 1986, and secs. 5061 and 5073 of the Code)

Present Law

The excise taxes on alcoholic beverages and tobacco products are imposed on removal of a taxable product from bonded premises. Tax on domestically produced articles (and distilled spirits imported in bulk) is paid with respect to semi-monthly periods, with tax being due 14 days after the close of each semi-monthly period. Tax on imported products (other than distilled spirits imported in bulk) is due 14 days after the date on which the taxable product enters the customs territory of the United States.

Explanation of Provision

The bill conforms the payment periods for excise taxes imposed on imported alcoholic beverages and tobacco products generally to those presently applicable to domestic products. Thus, tax on these imported products will be paid with respect to semi-monthly periods, with tax being due 14 days after the close of each semi-monthly period.

Part 3. Miscellaneous Tax Provisions

A. Individual Income Tax Provisions

1. Exemption of Mutual Fund Shareholder Expenses from 2-Percent Floor on Miscellaneous Itemized Deductions (sec. 6701 of the bill and sec. 67(c) of the Code)

Present Law

Miscellaneous itemized deductions generally are allowable only to the extent exceeding two percent of the taxpayer's adjusted gross income (sec. 67). Under present law, the two-percent floor applies with respect to indirect deductions through pass-through entities such as regulated investment companies ("mutual funds"). However, present law includes exceptions in the case of other pass-through entities, such as real estate investment trusts, cooperatives, and certain trusts and estates.

Reasons for Change

The committee believes that in light of the administrative difficulties and confusion to millions of taxpayers that would result from applying the two-percent floor to mutual fund expenses, the present-law exceptions from the floor for certain pass-through entities should be expanded to include publicly offered mutual funds.

Explanation of Provision

Under the provision, the two-percent floor would not apply to indirect deductions with respect to publicly offered mutual funds. The latter term means a mutual fund the shares of which are (1) continuously offered pursuant to a public offering (within the meaning of sec. 4 of the Securities Act of 1933, as amended), (2) regularly traded on an established securities market, or (3) held by or for no fewer than 500 persons at all times during the taxable year. The provision authorizes the Treasury to prescribe regulations decreasing the minimum 500-shareholder requirement in the case of mutual funds that experience a loss of shareholders through net redemptions of their shares.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

2. Parent May Elect to Claim Unearned Income of Dependent on Return of Parent (sec. 6702 of the bill and sec. 6012 of the Code)

Present Law

The unearned income of a child under age 14 in excess of a specified limit is taxed to the child at the top marginal rate of his or her parents. A dependent child with any unearned income must file a tax return if his or her total income exceeds $500.

Reasons for Change

The committee is concerned about the complexity of the tax return filing requirements necessitated by the provisions relating to the taxation of unearned income of children under 14. Consequently, the bill simplifies those filing requirements by permitting an election to be made to include the unearned income (below specified limits) of a child on the parents' tax return. The committee believes that this election makes these provisions more consistent with the underlying tax policy of these provisions.

Although the committee was desirous of enacting this simplification so that it would be effective for tax returns filed next Spring, the committee recognized that the IRS would not be able to administer these provisions without additional time for implementation. Consequently, the committee has made these simplifications effective for returns filed in the Spring of 1989.

Explanation of Provision

The bill provides that parents may elect made to include their child's unearned income on the parents' income tax return. This election may be made only if the income of the child is entirely unearned income and is less than $5,000. The provision applies only to children under the age of 14. The $500 standard deduction with respect to the unearned income of children under age 14 is unchanged by the bill. Thus, the first $500 of unearned income of these children would remain untaxed.

The intent of the committee is that, after subtracting the child's standard deduction of 4500, the remaining unearned income of the child would be reported as income on the parents' return (such as on the line labelled "Other Income"). The bill provides that all of this remaining income is taxed as if it were the parents'. This is done to make the filing requirements as simple as possible. The IRS may require that the taxpayer identification number of such child be included on the same line of the tax return on which the income is reported.

The bill also provides that including this income of the child on the parents' tax return is to have no effect for gift tax purposes.

The committee intends that the making of this election will not broaden the assets available to the IRS for collection purposes. Thus, the IRS may collect the portion of the family's tax liability attributable to the income of the child by levying upon the assets of the child, but the committee inends that the IRS ordinarily should not levy upon the assets of the child to satisfy the portion of the family's tax liability attributable to the income of the parents.

Effective Date

The provision is effective for taxable years beginning after December 31, 1987. Thus, the provision is first effective for 1988 tax returns, which are generally due by April 15, 1989.

3. Medical Expense Deduction for Certain Radon Mitigation Costs (sec. 6703 of the bill and sec. 213 of the Code)

Present Law

Taxpayers who itemize deductions are allowed to deduct medical expenses to the taxpayer, spouse, or a dependent, to the extent that such expenses exceed 7.5 percent of adjusted gross income. The cost of a permanent improvement to a residence may be deductible as a medical expense if the expenditure is directly related to medical care, but only for any portion of the cost that exceed the increased value of the property attributable to the improvement (Treas. Reg. sec. 1.213-1(e)(1)(iii)).

Reasons for Change

Public health officials have informed the committee that they have become increasingly concerned with the problem of indoor household contamination by radon gas and the danger such contamination poses to health.

Explanation of Provision

Under the provision, specified types of home improvement costs incurred to mitigate radon gas exposure are treated as medical care expenses eligible for the section 213 deduction. This provision applies only if the taxpayer shows, through measurements taken by a State or local government or by a measurement business approved by the Environmental Protection Agency (EPA), that radon levels in the taxpayer's home exceeded the level of safety recommended by the EPA.

The provision specifies that the home improvements for mitigating radon gas exposure that are eligible for the medical expense deduction are: (1) sub-slab ventilation; (2) drain-tile ventilation; (3) block-wall ventilation; and (4) sump ventilation. In addition, Treasury regulations may provide that installation of air heat exchangers and air filtration systems as well as other techniques also may be eligible for the deduction, if the taxpayer shows that one of the four specific techniques listed above failed to reduce the concentration of radon gas in the air of the residence to the level of safety recommended by the EPA.

Effective Date

The amendment is effective for taxable years beginning after December 31, 1987.

4. Certain Changes in Treatment of Foster Care Payments Made Retroactive to 1979 (sec. 6704 of the bill and sec. 131 of the Code)

Present Law

Under section 131 as in effect prior to amendment by the Tax Reform Act of 1976, a foster parent generally could exclude from gross income amounts paid as reimbursements for the expenses of caring for a foster child under the age of 19 in the foster parent's home. To qualify for exclusion, the payments must have been made by a State or political subdivision or by a State-licensed, tax-exempt child-placement agency. The exclusion also applied to certain difficulty of care payments.

To implement the exclusion under prior law for reimbursements of foster care expenses, the Internal Revenue Service required foster parents to account for the expenses incurred for each foster child in their care. This accounting was required because, under prior law, any excess of foster care payments over actual expenses in the year was includible in gross income.

The 1986 Act made two changes in the operation of section 131. First, for taxable years beginning on or after January 1, 1986, the exclusion was made applicable to amounts paid for foster care, rather than for reimbursements of foster care expenditures. Essentially, this modification eliminated certain recordkeeping requirements. Second, the exclusion was extended to payments for a foster care individual who had attained the age of 19 (adult foster care). This provision also was effective for taxable years beginning on or after January 1, 1986.

Reasons for Change

The committee determined that the recordkeeping requirements required under prior law were burdensome to foster care providers. The committee believes that retroactive elimination of such requirements is appropriate and that relief should be granted to those foster care providers who had not been able to satisfy the prior-law substantiation requirements.

Explanation of Provision

The bill provides that the amendment made by the Tax Reform Act of 1986 removing recordkeeping requirements as a condition to the excludability of foster care payments applies retroactively to taxable year beginning after 1978. (The bill does not change the effective date for the exclusion of foster care payments for qualified individuals who have attained age 19 as provided in the 1986 Act.) Appropriate rules relating to waiver of the statute of limitations are included in the provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 1987.

5. Treatment of Certain Amount Paid to or for the Benefit of Institutions of Higher Education (sec. 6705 of the bill and sec. 170 of the Code)

Present Law

A contribution to a charitable organization is deductible under Code section 170 only to the extent it constitutes a voluntary transfer of money or property without receipt or expectation of financial or economic benefit.[1] As a general rule, where consideration in the form of admissions or other privileges or benefits is received in connection with payments by patrons of fund-raising activities, the payments are presumed not to be gifts. In such a situation, the burden is on the taxpayer to establish that the amount paid does not constitute the purchase price of the privileges or benefits and to establish what part (if any) of the payment in fact qualifies as a contribution.[2]

The Internal Revenue Service has issued guidelines (Rev. Rul. 86-63) [3] concerning whether payments to athletic scholarship programs constitute charitable contributions deductible under section 170 when the payments afford the right to purchase preferred seating at a university's home football games.

Reasons for Change

The committee believes that in light of problems in applying the IRS administrative guidelines in Rev. Rul 86-63 to varying factual circumstances and differing types of programs at hundreds of colleges and universities, a statutory rule should be adopted to assist individual taxpayers, educational institutions, and the IRS in determining the tax treatment of such payments. Under this provision, a flat percentage of certain payments to or for the benefit of a college or university (other than amounts separately paid for tickets) is treated as if constituting a charitable contribution, without the need to examine in each particular case whether the payor should be viewed as making a gift, or to determine the value of the right to seating received by the payor for his or her payment. The committee emphasizes that adoption of this special rule for administrative convenience with respect to certain payments to or for the benefit of colleges and universities does not affect the general principles—as set forth, for example, in Rev. Rul. 67-246 [4]—concerning the tax treatment of payments to charitable organizations in connection with which the payor becomes entitled to admissions, free or discounted merchandise, subscriptions to magazines, or other privileges or benefits.

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[1] See, *e.g.*, H.R. Rep. No. 1337, 83d Cong., 2d Sess. A44 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 196 (1954); *Channing* v *U.S.*, 4 F. Supp. 33 (D Mass.), *aff.'d per curiam*, 67 F.2d 986 (1st Cir. 1933), *cert. denied*, 291 U.S. 686 (1934); Treas. Reg. sec. 1.170A-1(c)(5).

[2] Rev. Rul. 67-246, 1967-2 C.B. 104; see also Rev. Rul. 76-185, 1976-1 C.B. 60.

[3] 1986-1 C.B. 6, superseding Rev. Rul. 84-132, 1984-2 C.B. 55.

[4] 1967-2 C.B. 104; see also Rev. Rul. 76-185, *supra*.

Explanation of Provision

Under the provision, if a taxpayer makes a payment to or for an institution of higher education,[5] and the taxpayer thereby receives (directly or indirectly) the right to seating or the right to purchase seating in an athletic stadium of such institution, 80 percent of such payment (not including any amount separately paid for tickets) is treated as a charitable contribution.

For example, assume that a taxpayer who itemizes makes a $300 payment to a particular athletic scholarship program maintained by a university, and that the program is eligible to receive tax-deductible contributions. A minimum payment of $300 is required to become a "member" of the program. The only benefit afforded members is that they are permitted to purchase, by paying the stated price of $120, a season ticket to the university's home football games in a designated area in the stadium. Because the games regularly are sold out well in advance, tickets to the games covered by the season ticket would not have been readily available to the taxpayer had not payment to the program been made. The $300 membership fee is paid annually, and a member is required to make a separate $300 payment for each season ticket the member purchases.

Under the provision, the taxpayer in the above example may claim $240 (80 percent of the $300 payment) as a charitable deduction under section 170. The taxpayer may not claim a charitable deduction for the remainder of the $300 payment ($60) or for any part of the $120 payment required to obtain a season ticket. The same tax consequences also apply under the provision even if, in the above example, tickets to games would have been readily available whether or not the taxpayer had made the $300 payment to the athletic scholarship program. Thus, in the latter situation, the taxpayer's charitable deduction is limited to $240.

Effective Date

The provision is effective for amounts paid in taxable years beginning after December 31, 1983.

6. Extension of Certain Nonrecognition of Gain Rules to Ambassadors and Foreign Service Officers (sec. 6706 of the bill and sec. 1034 of the Code)

Present Law

In general, a taxpayer may defer recognition of gain on the sale of a principal residence if the taxpayer reinvests the sales price of the old residence in a new principal residence within a specified period of time (sec. 1034). An individual, including a Foreign Service officer, who has a tax home overseas is allowed to defer recognition of gain on the sale of a principal residence for up to four years (sec. 1034(k). A replacement period of up to eight years is allowed for members of the Armed Forces who are on extended active duty and stationed outside the United States (sec. 1034(h)).

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[5] The term "institution of higher education" means an organization described in sections 170(b)(1)(A)(ii) and 3304(f).

Reasons for Change

Ambassadors and Foreign Service officers often are assigned to posts abroad for extended periods of time. If as principal residence in the United States is sold just before or during the assignment abroad, such an individual may not be in a position to reinvest the proceeds from the sale of the old principal residence into a new principal residence in the United States within the present-law replacement period. Accordingly, the committee believes that it would be more equitable to make such individuals eligible for the longer replacement period that applies under current law to members of the Armed Forces who are on extended active duty and stationed outside the United States.

Explanation of Provision

The bill extends the replacement period (up to eight years) allowed under section 1034(h) also to apply to an Ambassador or a Foreign Service officer who is on an assignment abroad for the United States Government.

Effective Date

The amendment applies to sales of old residences after December 31, 1982.

7. Treatment of Certain Technical Personnel (sec. 6707 of the bill, sec. 1706 of the Tax Reform Act, and sec. 530 of the Revenue Act of 1978)

Present Law

Background of 1978 Act

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common law test. Under this test, an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished (Treas. Reg. sec. 31.3401(c)-(1)(b)).

If an employer-employee relationship exists, the service-recipient is subject to social security taxes under the Federal Insurance Contribution Act (FICA) and unemployment taxes under the Federal Unemployment Tax Act (FUTA), and is required to withhold and pay over FICA and income taxes imposed on the worker. On the other hand, if there is no employer-employee relationship, the service-recipient is not subject to employment taxes; the worker pays self-employment tax in lieu of FICA tax and makes quarterly estimated income tax payments. Historically, the total FICA tax rates imposed on an employer and employee have been significantly higher than the rate of self-employment tax on the same amount of wages. (This difference in tax rates is being phased out, pursuant to the Social Security Amendments of 1983. In years beginning after 1989, the difference will be substantially eliminated.)

Revenue Act of 1978

In response to controversies between the IRS and taxpayers with regard to employment status, Congress enacted section 530 of the Revenue Act of 1978 (P.L. 95-600). That provision, which originally was intended to be a temporary measure pending futher legislation but has been extended indefinitely, generally allowed a taxpayer to treat a worker as not being an employee—regardless of the individual's actual status under the common law test—unless the the taxpayer had no reasonable basis for such treatment. Under section 530, a reasonable basis was considered to exist for this purpose if the taxpayer reasonably relied on certain factors, such as a long-standing industry practice or the past failure of the IRS to raise such an employment tax issue on audit.

This relief under section 530 was made available with respect to an individual only if certain additional requirements are satisfied.

Although section 530 provides relief only with respect to the employment tax liability of the service recipient, it has been widely used to justify claims of independent contractor status for income tax purposes, both by the "employer" and by individuals whose "employer" claims relief under section 530. An employer might wish to treat workers as independent contractors for income tax purposes to attempt to avoid otherwise required coverage of such individuals under the employer's retirement and employee benefit plans. Such status for income tax purposes also conveys certain tax advantages with respect to the workers, such as the ability of an independent contractor to maintain a Keogh plan and to take certain business deductions unavailable to employees.

1986 Act

Section 1706 of the 1986 Act provided that section 530 of the Revenue of 1978 does not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.

Under this exception to section 530, individuals who are retained by firms and who provide the technical services described above are to be classified, for income and employment tax purposes, as employees or as independent contractors under the common-law test without regard to section 530. Further, by virtue of this exception of section 530, the prohibition in section 530 against issuance of Treasury regulations or revenue rulings concerning employment tax status does not apply with respect to the employment tax status of such individuals.

Reasons for Change

The enactment of section 1706 has caused significant uncertainty and disruption among certain components of the technical services industry. The committee believes that much of this disruption can be eliminated by (1) confirming present practices by applying section 530 of the 1978 Act for income tax purposes, and (2) limiting section 1706 of the 1986 Act to FICA and FUTA taxes. At the same time, the committee believes that it is fair that the individuals who would be employees for income tax purposes but for this modification of section 1706, be subject to certain income tax withholding.

Explanation of Provision

Under the bill, the committee intends to confirm present practices by applying the rules of section 530 of the 1978 Act for income tax purposes. The bill further provides that section 1706 of the 1986 Act does not apply for income tax purposes, so that for income tax purposes, section 530 applies to technical service personnel.

The bill further provides that individuals who would be employees of a technical services firm for income tax purposes, are subject to income tax withholding at a 10-percent rate with respect to any compensation that would be wages under section 3401(a) but for the elimination of section 1706 for income tax purposes.

Effective Date

The provision applies to remuneration paid after December 31, 1987.

B. Capital Cost Provisions

1. Cost Recovery for Citrus Trees (sec. 6711 of the bill and sec. 168 of the Code)

Present Law

In general

Under the present-law accelerated cost recovery system, depreciable property is assigned a recovery period that generally is based on the midpoint life of the property under the asset depreciation range ("ADR") system of the law in effect before 1981. The depreciation method generally applicable to property that is recovered over 3, 5, 7, or 10 years is the double declining balance method, switching to the straight-line method at a time to maximize the depreciation allowance. For property recovered over 15 or 20 years, the applicable depreciation method is the 150-percent declining balance method, switching to the straight-line method at a time to maximize the depreciation allowance.

The Treasury Department is authorized to prescribe a new class life for any property or class of property (other than real property) when appropriate and to prescribe a class life for any property that does not have a class life. Any such classification or reclassification applies only to property placed in service after the date of classification or reclassification. Certain assets specifically assigned a recovery period may not be assigned a longer class life by Treasury, if the property is placed in service before January 1, 1992.

Citrus trees

No published class life is specified under the ADR system for citrus trees. Under the accelerated cost recovery system as in effect before the enactment of the Tax Reform Act of 1986, citrus trees were assigned a recovery period of 5 years.

Reason for Change

The committee believes that the Internal Revenue Service intends to classify citrus trees as land improvements (which are assigned an ADR midpoint of 20 years). Thus, the applicable recovery period for citrus trees would be 15 years. The committee believes that a 15-year recovery period is inappropriate for citrus trees in light of the damaging freezes that may substantially shorten the lives of the trees.

Explanation of Provision

The bill assigns citrus trees a 7-year recovery period and an ADR midpoint of 15 years.

The committee expects Treasury to study the economic life of citrus trees in light of the increased frequency of damaging freezes. Treasury is to take into account the effect of damaging freezes on the economic life of citrus trees.

Effective Date

The provision applies to property placed in service after December 31, 1986.

C. Corporate Provisions

1. NOL Carryforwards for Thrift Institutions (sec. 6721(a) of the bill and sec. 382(1)(5)(F) of the Code)

Present Law

Net operating loss carryforwards are limited in certain circumstances if there is an ownership change of the loss corporation. Certain thrift institutions are subject to a special rule that prevents the limitation of losses in the case of transactions occurring before January 1, 1989, provided a 20 percent specifically defined continuity requirements is met.

Net operating loss carryforwards are not subject to limitation in the case of certain ownership changes occurring in the context of a bankruptcy or similar proceeding. However, if there is a second ownership change within two years, the losses may be limited.

Reasons for Change

Prior to the 1986 Act, thrift institutions now subject to the 20 percent specially defined continuity rule experienced only a phase out of their losses as the specially defined continuity requirement fell below 20 percent and not a complete limitation as under present law. The committee determined that it was appropriate to provide prior law to such institutions for the transition period prior to January 1, 1989.

The committee also believed it was desirable to clarify that certain troubled thrift transactions are not subject to the second ownership change rule.

Explanation of Provision

The bill provides prior law in the case of reorganization transactions with respect to thrift institutions that are subject to the special 20-percent rule under present law.

In this connection, it is also intended that if a regulatory agency obtains control of a troubled thrift institution as an interim measure in a reorganization transaction, followed by a second transaction in which control of the thrift is transferred to private parties, there is no limitation of losses that would not have occurred under prior law.

Effective Date

The provision is effective as if included in the Tax Reform Act of 1986.

2. Relief From Recognition of Corporate Level Gain Involving Transfer of Residential Cooperative units (sec. 6721(b) of the bill and sec. 336 of the Code)

Present Law

Gain is recognized by the distributing corporation if appreciated property is distributed to shareholders in a liquidating or a nonliquidating distribution. Shareholders who receive appreciated property in such a distribution in exchange for their stock generally recognize gain to the extent that the value of the property distributed exceeds their bases in the corporates stock.

Section 1034 of the Code permits the deferral of gain if a taxpayer recognizes gain on the sale of his principal residence and acquires another principal residence within a 2-year period. For purposes of that section, stock held by a tenant-stockholder in a cooperative housing association is included in the definition of a personal residence if the shareholder used the house or apartment that he was entitled to occupy as such shareholder as his principle residence.

Reasons for Change

The committee believes that it is generally appropriate to provide relief from corporate level gain recognition in the case of a distribution of appreciated property to a shareholder of a cooperative housing association if the exchange of the shareholder's stock for such property would qualify for nonrecognition of gain under section 1034 of the Code.

Explanation of Provision

The bill provides that, except as provided in regulations, no gain or loss shall be recognized at the corporate level on the distribution to a tenant shareholder of property in exchange for his stock to the extent the exchange qualifies for nonrecognition at the shareholder level under section 1034 of the Code.

It is expected that the Treasury Department will prescribe regulations providing reporting or other procedures to assure that the intended relief is provided only in cases where the house or apartment is in fact used by the taxpayer as his principal residence both before and after the distribution. Also, the Treasury Department may prescribe rules to assure that there is a full corporate level recapture of tax benefits (if any) that may have been claimed at the corporate level to the extent the same benefits could not have been claimed by the shareholder if he had owned the house or apartment directly and used it as his principal residence.

Effective Date

The provision is effective as if included in the Tax Reform Act of 1986.

3. Net Operation Loss Rules for Bankruptcy (sec. 6721(c) of the bill and sec. 621(f)(5) of the Reform Act)

Present Law

In the case of certain bankruptcy proceedings, the net operating loss limitations of the 1986 Act do not apply to an ownership change resulting from the reorganization or proceeding if a petition in the case was filed with a court before August 14, 1986.

Reasons for Change

The committee believes it is desirable to clarify the treatment of certain situations in which stock of a corporation in bankruptcy is acquired during the pendency of the bankruptcy proceeding.

Explanation of Provision

When stock of a corporation is acquired during the pendency of a bankruptcy, an ownership change may occur and losses may be limited. However, the bill provides that the Treasury Department shall provide rules for the redetermination of whether there has been an ownership change based on the value of the stock immediately after the completion of the bankruptcy proceeding. It is expected that if the value of the stock received at that time by the shareholders with respect to any stock that was acquired during the proceeding in a transaction that triggered an ownership change does not in fact represent more than 50 percent of the value of the corporation, an amended return could generally be filed with respect to the prior years for which the losses were limited (without regard to the otherwise applicable statute of limitations).

Effective Date

The provision is effective as if included in the Tax Reform Act of 1986.

D. Tax Administration

1. Disclosure of Return Information to Certain Cities (sec. 6731 of the bill and sec. 6103 of the Code)

Present Law

Section 6103 provides for the confidentiality of returns and return information of taxpayers. The conditions under which returns and return information can be disclosed are specifically enumerated in that section. Disclosure of return and return information to local income tax administrators generally is not permitted. However, a specific exception to this rule provides that any city with a population in excess of 2 million that imposes an income (or wage) tax may, if the Secretary in his sole discretion so provides, receive returns and return information for the same purposes for which States may obtain information, subject to the same safeguards as apply to States.

Cities that receive information must reimburse the Internal Revenue Service for its costs in the same manner as a State must under present law. Population is determined on the basis of the most recent decennial United States census data available.

Any disclosure is required to be in the same manner and with the same safeguards as disclosure is made to a State. The requirements of maintaining a system of standardized requests for information and the reasons for the request and of maintaining strict security against release of the information are also made applicable to the local agencies. Disclosure is permitted only for the purpose of, and only to the extent necessary in, the administration of a local jurisdiction tax. Disclosure of returns or return information to any elected official or the chief official (even if not elected) of the local jurisdiction is not permitted.

Any unauthorized disclosure of returns and return information by an employee of an agency receiving this information subjects the employee to the fine and imprisonment provided by section 7213 and to the civil action provided by section 7431.

Reasons for Change

The Committe believes that the rule that allows the Secretary, in his sole discretion, to disclose returns and return information, under specified safeguards and conditions, to local tax administrators in cities that impose an income (or wage) tax and have a population in excess of 2 million should be amended to apply to cities that impose such a tax and have a population in excess of 1.5 million.

Explanation of Provision

The bill modifies section 6103(b)(5) so that the Secretary, in his sole discretion, may disclose returns and return information to local tax administrators in cities with a population in excess of 1.5 million (rather than the present-law requirement of a population in excess of 2 million) that impose a tax on income or wages. The various safeguards and conditions governing disclosure of returns and return information to local tax administrators would remain unchanged. Moreover, unauthorized disclosure of returns or return information by an employee of a local agency receiving this information would continue to subject the employee to fine and imprisonment provided by section 7213 and to the civil action provided by section 7431.

Effective Date

This provision is effective on the date of enactment of the bill.

2. Taxpayer Procedures (secs. 6732–6755)

a. Disclosure of rights and obligations of taxpayers (sec. 6732 of the bill

Present Law

The IRS currently provides information to taxpayers by means of various notices and publications. Some taxpayers may not receive sufficient information to understand the tax collection process at the time that he or she is contacted by the IRS in a context that may lead to a dispute.

Reasons for Change

The committee believes that it would benefit taxpayers and the tax administration system if taxpayers coming into contact with the IRS understood their rights and obligations early in the dispute resolution process.

Explanation of Provision

The bill requires the Secretary to prepare a brief and understandable statement of the rights and obligations of the taxpayer and the Service during the audit, appeals, refund, and collection processes. This comprehensive explanation of the tax collection process would be provided to the taxpayer on the first occasion that the Service contacts the taxpayer (for a reason other than to provide forms) concerning the determination or collection of any tax.

The bill also provides that the statement of rights and obligations shall be submitted to the Committee on Ways and Means, the Committee on Finance, and the Joint Committee on Taxation within 180 days of the date of enactment of this Act. The statement shall not be distributed before 90 days have elapsed following transmittal.

b. Procedures involving taxpayer interviews (sec. 6733 of the bill and sec. 7519 of the Code)

Present Law

The Code provides that the Secretary shall select the time and place for an examination of a taxpayer and that such time and place shall be reasonable (sec. 7605). The IRS has not promulgated regulations explaining this provision.

The rules relating to recordings of interviews also are not provided by statute or regulations. Generally the IRS permits a taxpayer to make an audio recording of an in-person interview at his or her own expense upon prior notice to the IRS.

The IRS provides written explanatory materials to taxpayers in advance of the initial audit interview and at other times thereafter. If a power of attorney has been executed properly in favor of a person eligible to practice before the IRS, the taxpayer is entitled to representation by that person during all stages of the administrative process.

Reasons for Change

The committee believes that there should be more guidance provided concerning taxpayer rights with respect to interviews conducted by the IRS. In addition, the taxpayer should have every opportunity to make use of a representative in administrative proceeding before the IRS.

Explanation of Provision

The bill requires the Secretary to publish regulations within one year after the date of enactment enumerating standards for determining whether the selection of a time and place for an interview is reasonable. For example, it is generally not reasonable to require a taxpayer to go to an IRS office other than the one located closest to his or her home. Similarly, it is generally not reasonable to audit a taxpayer at his or her place of business if the business location is so small that doing so essentially requires the taxpayer to close the business. It would, for example, be unreasonable if the time or place presented the possibility of physical danger to the IRS agent.

The bill provides that a taxpayer may make an audio recording of an in-person interview at his or her own expense upon giving advance notice to the Service. The Service would be allowed to make such a recording if the Service provides a transcript to the taxpayer at cost upon request. In all proceedings other than those relating to criminal matters, the Service would be required to give the taxpayer prior notice of the intent to record.

In order to better permit a taxpayer to participate in an interview in an informed manner, the bill would require an employee of the Service to explain to a taxpayer the audit process and the taxpayer's rights under such process prior to the initial interview relating to the determination or collection of any tax. Should the taxpayer indicate in any manner that he or she would like to consult with an attorney, public accountant, enrolled agent, or enrolled acturary, the IRS would be required to discontinue the interview to permit such consultation unless the interview was initiated by an administrative summons.

The bill further provides that a taxpayer may be represented during all stages of the administrative process by any attorney, public accountant, enrolled agent or enrolled actuary who is not disbarred from practice before the Service and has a properly executed power of attorney from the taxpayer. In the absence of an administrative summons, the Service could not require a taxpayer to accompany his or her representative to an interview. However, the IRS could notify the taxpayer directly that the taxpayer's representative was responsible for unreasonable delay or hindrance of an examination or investigation of the taxpayer.

Effective Date

The provision takes effect for interviews conducted on or after the date which is 30 days after the date of enactment.

c. Advice of Internal Revenue Service (sec. 6734 of the bill and sec. 6404 of the Code)

Present Law

The Service currently issues written advice in a number of contexts. Upon request of a taxpayer, it may issue a private letter ruling. The taxpayer to whom it is issued is entitled to rely on it. However, not all written advice is provided in this manner. For example, correspondence from a district office or service center may provide a taxpayer with advice.

Section 6404(e) currently provides the Service with authority to abate all or any part of the interest attributable to either a failure of a Service official to perform a ministerial act in a timely manner or an error in performing a ministerial act.

Reasons for Change

The Service should have the authority to redress unfair results that follow from providing taxpayers with erroneous written advice.

Explanation of Provision

The bill provides that the Secretary generally is given the authority to abate all or any part of the interest and penalties imposed with respect to a deficiency that is attributable to erroneous written advice of the Service furnished to a taxpayer in response to a specific written request of the taxpayer, unless the taxpayer failed to provide adequate or accurate information.

Effective Date

This provision is effective on the date of enactment.

d. Taxpayer assistance orders (sec. 6735 of the bill and sec. 7811 of the Code)

Present Law

There currently is a Taxpayer Ombudsman in the Office of the Commissioner. The Ombudsman administers the IRS' problem resolution program, which is designed to resolve a wide range of problems that are not resolved appropriately through normal operating procedures or administrative channels. Managers in the regional and district offices of the Service have authority to stop enforcement actions in order to determine whether the tax administration system is operating correctly with respect to the taxpayer.

Reasons for Change

The committee believes that there should be statutory authority for the Taxpayer Ombudsman to act upon behalf of taxpayers.

Explanation of Provision

The bill provides the Taxpayer Ombudsman with the authority to issue a taxpayer assistance order with respect to a taxpayer if he or she finds that (1) the taxpayer is suffering or is about to suffer from an irreparable loss as a result of the manner in which the tax laws are being administered by the Secretary and (2) with respect to the taxpayer, the Secretary has failed to carry out his or her duties under the law or has violated the applicable law or administrative procedures,. The order can provide for any appropriate action or inaction, including the release of property subject to levy, and is binding on the Service unless reversed by high level management such as a district director. This provision is not intended to limit the existing authority of the Ombudsman or other Service personnel to assist taxpayers.

The bill requires the Secretary to issue such regulations as the Secretary deems necessary within 90 days of enactment in order to carry out the purposes of the section and assure that taxpayers are provided uniform access to available taxpayer assistance services.

Effective Date

The provision takes effect on the date of enactment.

e. Office of Inspector General (sec. 6736 of the bill)

Present Law

The Treasury Department currently has a non-statutory Inspector General with internal audit and investigative responsibilities for the Department, except for its four law enforcement agencies: the IRS, the United States Secret Service, the United States Customs Service, and the Bureau of Alcohol, Tobacco and Firearms. The non-statutory Inspector General has general oversight responsibilities over the internal audit and investigative activities of these four agencies.

Reasons for Change

The committee believes that it would be beneficial to have a statutory Inspector General at the Treasury Department to provide independent oversight of the agency.

Explanation of Provision

The bill establishes a statutory Inspector General within the Treasury Department. The internal audit staffs of the IRS, the United States Secret Service, the United States Customs Service, and the Bureau of Alcohol, Tobacco and Firearms are transferred to the Office of the Inspector General.

The bill provides the Inspector General with general oversight responsibility for the agency. In addition, the Inspector General has the authority to conduct an investigation of any officer or employee of the Treasury Department if (1) the Secretary or the Deputy Secretary of the Treasury requested the investigation, (2) the investigation concerned senior officers or employees of the Department, or (3) the investigation involved alleged notorious conduct or any other matter which the Inspector General deemed especially sensitive or of departmental significance.

The bill provides that the Secretary may prohibit the Inspector General from conducting any audit or investigation to the extent necessary to protect the confidentiality of information concerning (1) ongoing criminal investigations or proceedings, (2) sensitive undercover operations, (3) the identity of confidential sources, including protected witnesses, (4) deliberations and decisions on policy matters, including documented information used as a basis for making policy decisions, the disclosure of which could reasonably be expected to have a significant influence on the economy or market behavior, or (5) other matters the disclosure of which would constitute a serious threat to national security or to the protection of any person authorized to receive protection under section 3056 of title 18 of the United States Code. Upon doing so, the Secretary is required to notify the Inspector General in writing, who in turn is required to notify Congress within 30 days.

Effective Date

The provision takes effect on the date of enactment.

f. Basis for evaluation of Internal Revenue Service employees (sec. 6736 of the bill)

Present Law

The Service has a written policy against the use of production quotas or goals based upon sums collected to evaluate individual enforcement officers, appeals officers, and reviewers.

Reasons for Change

The committee believes that it is inappropriate to use enforcement statistics in evaluating individual enforcement officers, appeals officers, and reviewers.

Explanation of Provision

The bill prohibits the Service from using records of tax enforcement results to evaluate enforcement officers, appeals officers, and reviewers, or to impose or suggest production quotas or goals. Each district director is required to provide the Commissioner with a monthly certification concerning compliance with this provision.

Effective Date

The provision applies to evaluations conducted on or after the date of enactment.

g. Application of the Regulatory Flexibility Act to the Internal Revenue Service (sec. 6738 of the bill and sec. 7805 of the Code)

Present Law

The Regulatory Flexibility Act requires a Federal agency to publish an analysis describing the impact of proposed rules on small businesses whenever its rules are likely to have a significant economic impact on a substantial number of small entities. The analysis must include, among other items, a description of any alternative rule that would accomplish the objectives of the proposed rule and minimize the impact on small businesses. An exception generally applies to interpretative regulations.

The Service is subject to the Regulatory Flexibility Act. However, it takes the position that it need not submit an analysis and meet the other requirements of the Act with respect to most proposed regulations it promulgates because they are interpretative.

Reasons for Change

The committee is concerned that regulations promulgated by Treasury may have a serious impact on small businesses.

Explanation of Provision

The bill provides that regulations are considered interpretative under the Regulatory Flexibility Act only if the Secretary certifies that the regulation is substantially the only alternative that meets the mandate of the statute.

Effective Date

The provision applies to any rule or regulation prescribed after the date of enactment.

h. Preliminary letter of deficiency (sec. 6739 of the bill and sec. 6211A of the Code)

Present Law

The Code generally requires that a notice of deficiency be sent to the taxpayer by certified or registered mail before the IRS can collect the tax. The Code does not require that additional letters be sent to taxpayers prior to this letter.

Reasons for Change

The committee believes that taxpayers should receive a preliminary notice of potential tax liability.

Explanation of Provision

The bill requires that a preliminary letter of deficiency be sent to the taxpayer by certified or registered mail whenever the Secretary determines that there is a potential deficiency with respect to a tax subject to the deficiency procedures. This letter generally is required to be sent at least 30 days before a deficiency notice under section 6212 is sent. An exception to the 30-day requirement would apply if the statute of limitations would expire within 90 days or if the taxpayer provides a written waiver of right to such letter.

Effective Date

The provision takes effect on the date of enactment.

i. Content of tax due and deficiency notices (sec. 6740 of the bill and sec. 7520 of the Code)

Present Law

The Code does not specify the content of the statutory notice of deficiency sent pursuant to section 6212. However, the Service currently explains the basis of a deficiency in that notice. A description of interest owed is not included because it is not part of the deficiency and is only charged on assessment.

Reasons for Change

The committee believes that the Service should provide as much information as possible to taxpayers as early as possible in the administrative process. In this manner taxpayers can respond promptly and usefully to contacts by the Service and assert their positions more effectively.

Explanation of Provision

The bill requires the Secretary to set forth the basis for an asserted liability in any tax due notice, preliminary letter of deficiency, statutory notice of deficiency under section 6212, or other specified notice. In addition, the bill requires that a notice identify separately the amounts attributable to interest or specific penalties.

Effective Date

This provision takes effect 180 days after the date of enactment.

j. Fuller explanation of basis for assessing penalties (sec. 6741 of this bill)

Present Law

The majority of penalties provided in the Code are assessed by the Service based on the presence or absence of specific objective facts, such as the failure to receive a timely return or payment.

Reasons for Change

The committee is aware that the reasons that the IRS assesses penalties are not alway clear to taxpayers.

Explanation of Provision

The bill directs the Service to issue regulations within 90 days of the date of enactment requiring the IRS to explain and support their position in assessing any penalties. The Comptroller General would be required to study revenue agent reports and similar Service documents and prepare a report concerning the quality of Service decisions to impose penalties.

k. Installment payment of tax liability (sec. 6742 of the bill and sec. 6159 of the Code)

Present Law

The Service is not required to offer installment payment agreements to taxpayers; it evaluates the ability of the taxpayer to pay the tax in considering whether an installment agreement is appropriate. A change in the financial condition of the taxpayer may result in modification of the installment payment agreement.

Reasons for Change

The committee believes that the statute should provide standards relating to the termination of installment agreements executed by the Service. This would provide taxpayers a degree of predictability with respect to their financial obligations to the Service.

Explanation of Provision

The bill provides the Secretary with the authority to enter into a written installment payment agreement with the taxpayer upon a determination by the Secretary that an installment payment agreement would facilitate collection of the tax, interest, or penalties owed by a taxpayer. This agreement would be binding on the Service and the taxpayer unless (1) the information provided by the taxpayer was inaccurate or incomplete, (2) the financial condition of the taxpayer changed significantly, (3) the taxpayer failed to pay any installment when due under the agreement, or (4) the taxpayer failed to pay any other tax liability when due. The Secretary would be permitted to alter, modify or annul the installment agreement upon a determination that the financial condition of the taxpayer had changed significantly only following written notice to the taxpayer specifying the basis for the determination and the expiration of a 30-day waiting period.

Effective Date

The provision takes effect on the date of enactment.

1. Levy and distraint (sec. 6743 of the bill and secs. 6331, 6332, 6334 of the Code)

Present Law

Seizure of property for the collection of taxes

If a person fails to pay a tax within ten days after notice and demand for payment, the Service may collect the tax by seizure and sale of the taxpayer's property (levy) (sec. 7331(a) and Treas. reg. sec. 301.6331-1(a)). If the Service finds that the collection of tax is in jeopardy, the Service may collect the tax by levy without waiting the usual 10-day period.

Property suject to levey includes any property or rights to property, whether real or personal, whether tangible or intangible, belonging to the taxpayer, subject to specific statutory exemptions. Generally, levy may be made only after the individual has been notified in writing of the intent to levy (sec. 6331(d)). This notice must be given in person, left at the dwelling or usual place of business of the individual, or mailed (by certified or registered mail) to the individual's last known address, no less than ten days before the day of levy. The notice requirement, however, does not apply if there has been a finding that the collection of the tax is in jeopardy.

The Service may instruct the taxpayer's employer to pay to the Service a portion of the taxpayer's wages. This type of levy on wages is continuous from the time of the levy until the liability out of which the levy arose is satisfied or becomes unenforceable due to lapse of time.

In addition to the employer of the taxpayer, other parties holding the taxpayer's property may be forced to turn it over to the Service pursuant to a levy. In general, any person in possession of (or obligated with respect to) property or rights to property upon which levy has been made must surrender it upon demand (sec. 6332(a)). Any person who fails to surrender property upon demand becomes personally liable in an amount equal to the lesser of the value of the property or the amount of the tax liability with respect to which the levy was made, plus costs and interest from the date of the levy (sec. 6332(c)). In addition, that person is subject to a penalty equal to 50 percent of the amount for which there is personal liability. A person (other than the taxpayer) who surrenders the property at the government's demand is discharged from liability to the taxpayer (sec. 6332(d)).

Exemptions from levy

Present law exempts the following from levy:

(1) wearing apparel and school books;

(2) fuel, provisions, furniture, personal household effects, livestock, and poultry, not exceeding $1,500 in value;

(3) books and tools necessary for the trade, business, or profession of the taxpayer, not exceeding $1,000 in aggregate value;

(4) unemployment benefits;

(5) undelivered mail;

(6) certain annuity, pension, and military service disability payments;

(7) amounts payable under workers' compensation laws:

(8) so much of the wages, salary, or other income of the taxpayer as is necessary to comply with a prior judgment of a court of competent jurisdiction for support of the taxpayer's minor children; and

(9) a minimum amount of wages, salary, and other income (in general, $75 per week plus $25 per week for each dependent).

Reasons for Change

The committee believes that it is appropriate to extend the time period given to the taxpayer before levy can be made. The committee also believes that it is appropriate to expand the scope and value of property subject to levy.

Explanation of Provisions

The bill extends the current 10-day notice period preceding levy to 30 days. The bill also requires the notice preceding levy to include a description of the Code provisions and administrative procedures applicable to specified aspects of collection.

A number of the exemptions from levy are expanded by the bill. The exemption currently existing for fuel, provisions, furniture, and personal effects is increased from $1,500 to $10,000. The exemption for books, tools, and machinery is extended for taxpayers other than C corporations to include necessary trade or business property with a value up to $10,000. Finally, the bill exempts from levy a taxpayer's principal residence, motor vehicle used as the primary means of transportation to work, and any necessary tangible personal property used in the taxpayer's trade or business unless a district director or assistant district director personally approved the levy in writing or jeopardy was found to exist.

The bill imposes additional limitations on the situations in which the Service could continue a levy on property. The bill provides that a levy on salary or wages of a taxpayer is permitted to continue only until (1) the liability is satisfied or becomes unenforceable by reason of lapse of time, (2) an installment agreement is executed, or (3) the Service determines that the liability is unenforceable due to the taxpayer's financial condition. The bill provides that a levy with respect to other property must be released if (1) the liability is satisfied, (2) release will facilitate the collection of the liability, (3) an installment payment agreement has been executed, (4) the expenses of levy and sale exceed the liability, (5) the taxpayer can substantiate that the levy prevents the taxpayer from meeting necessary living expenses, or (6) the value of the property exceeds the liability and partial release would not hinder collection.

The bill would further restrict the cases in which the Service may levy on property. It provides that the Service may not levy on property if the estimated expenses of levy and sale exceed the fair market value of the property or the liability. Further, unless the case is a jeopardy case, no levy would be permitted with respect to the taxpayer's property on an appearance date specified in a summons issued by the Service.

The bill would require financial institutions to hold accounts garnished by the Service for 21 days after Service of notice of levy. This would give taxpayers an opportunity to notify the Service of errors with respect to seizures. Following the 21-day period, financial institutions must automatically surrender any account still subject to levy.

Effective Date

The provisions apply to levies made on or after the date of enactment.

m. Review of jeopardy levy and assessment procedures (sec. 6744 of the bill and sec. 7429 of the Code)

Present Law

Section 7429 of the Code provides special rules relating to the administrative and judicial review of jeopardy assessments.

Reasons for change

The committee believes that it would benefit taxpayers to permit special review of jeopardy levies in addition to jeopardy assessments.

Explanation of Provision

The bill extends exisitng rules of section 7429 relating to the review of jeopardy assessments to the review of jeopardy levies. In addition, it provides that the Tax Court has exclusive jurisdiction with respect to any civil action to challenge a jeopardy assessment or jeopardy levy if the taxpayer is already before the Tax Court with respect to any deficiency covered by the jeopardy assessment notice. In all other instances, the appropriate district court has exclusive jurisdiction with respect to such an action.

Effective Date

The provision applies to jeopardy levies and assessments made after the date of enactment.

n. Administrative appeal of liens (sec. 6745 of the bill and sec. 6326 of the Code)

Present Law

The Code does not provide specific procedures for the administrative appeal of administrative decisions concerning the collection of a tax liability.

Reasons for change

The committee believes that effective administrative procedures should be provided to facilitate the correction of errors made by the Service during the collection process.

Explanation of Provision

The bill requires the Secretary to prescribe by regulations an administrative procedure whereby any taxpayer could expeditiously appeal the imposition of a lien. The administrative appeal would folllow the imposition of the lien.

Effective Date

The provision takes effect on the date of enactment.

o. Jurisdiction to restrain certain premature assessments (sec. 6746 of the bill and secs. 6213 and 7482 of the Code)

Present Law

The Congress has established the Tax Court as a prepayment forum. Thus, taxpayers are entitled to challenge the Commissioner's deficiency determinations without having to first pay the tax in issue. Section 6213(a) of the Code guarantees this by providing as a general rule that no assessment or collection of a deficiency shall be made until the decision of the Tax Court has become final. If this restriction is violated, assessment and collection may be enjoined, notwithstanding the general prohibition against suits to restrain the assessment and collection of taxes (secs. 6213(a) and 7421(a)). However, jurisdiction to restrain assessment and collection rests with the district courts. Therefore, a taxpayer with a case before the Tax Court who is faced with a premature assessment is forced to seek relief in another forum, even though the premature assessment relates to the very deficiency that is the subject of the Tax Court action.

Reasons for Change

The committee believes that generally both taxpayers and the Government are well-served by permitting related issues to be litigated in the same forum.

Explanation of Provision

The bill gives the Tax Court exclusive jurisdiction to restrain the assessment and collection of any tax that is the subject of a petition pending before the Tax Court. However, the bill does not contemplate jurisdiction to restrain all premature assessments but rather only those made before or after the taxpayer has filed a timely petition with the Tax Court seeking the redetermination of the deficiency that is prematurely assessed. For example, if a statutory notice determined deficiencies in income tax for two taxable years and a timely petition challenged only the deficiency for one year, then the Tax Court would have jurisdiction to enjoin assessment or collection of the deficiency for the other year. Similarly, if a statutory notice determined a deficiency in income tax of $10,000 for one taxable year and a timely petition challenged only a part of that deficiency, then the Tax Court would have jurisdiction to enjoin assessment and collection of the entire $10,000 deficiency, including the part that had not been challenged. On the other hand, if a premature assessment is made prior to the filing of a petition with the Tax Court under section 6213(a), the taxpayer could sue to enjoin collection in a district court and that court would not lose jurisdiction if a timely petition under section 6213(a) was subsequently filed with the Tax Court.

The objective of the bill is to better serve the taxpayer by not forcing him to seek relief in another forum with respect to a deficiency where he already has sought relief in the Tax Court. An order of the Tax Court that restrains assessment and collection is treated as a decision of the Tax Court to provide the same review by a United States court of appeals that would be given to a similar order of a district court.

Effective Date

The provision applies to orders entered after the date of enactment.

p. Jurisdiction to enforce overpayment determinations (sec. 6747 of the bill and sec. 6512 of the Code)

Present Law

Section 6512(b) of the Code confers jurisdiction on the Tax Court to determine an overpayment in respect of a tax for which the Commissioner has determined a deficiency. However, the Tax Court does not have jurisdiction to order a refund (*United States ex rel. Girard Trust Co.* v. *Helvering,* 301 U.S. 540, 542 (1937)). If the Commissioner fails to refund the overpayment determined by the Tax Court, the taxpayer must seek relief in another forum.

Reasons for Change

If the Tax Court determines an overpayment and if the Commissioner fails to refund the overpayment, the committee believes that the taxpayer should not have to incur the additional time, trouble, and expense of enforcing the Tax Court's decision in another forum. Rather, the taxpayer should be able to enforce the decision in the very court which entered it.

Explanation of Provision

The bill provides the Tax Court with jurisdiction to order the refund of both an overpayment which has been determined by it and the interest on such an overpayment. However, the bill does not bar the taxpayer from enforcing the Tax Court's decision in whatever forum existing law provides.

The bill contemplates that if the Commissioner fails to refund the overpayment and the interest thereon within 120 days after the Tax Court's decision has become final, then upon motion by the taxpayer in the Tax Court, the Tax Court will have jurisdiction to order the refund of the overpayment and interest. In any such proceeding the burden will be on the Commissioner to establish that the delay was substantially justified. If the Commissioner fails to do so, the taxpayer will be entitled to interest on the overpayment (and on previously accumulated interest) at an increased rate and to an award of reasonable litigation costs as determined by the Tax Court. The Tax Court may also exercise such powers as are provided by section 7456(c). To the extent of any credit or offset made pursuant to section 6402, the Commissioner's failure to actually refund the overpayment and interest to the taxpayer will be conclusively presumed to be substantially justified, and the Tax Court will not have any jurisdiction over the validity or merits of any such credit or offset. This provision, however, is not intended to compromise a taxpayer's right to challenge the validity or merits of any such credit or offset in whatever forum existing law provides. An order disposing of a motion to order payment of an overpayment or interest, or to impose sanctions, under the new provision is appealable, but only with respect to the matters determined in that order.

The amendments made by this section apply to overpayments determined by the Tax Court which have not yet been refunded by the 90th day after the date of enactment.

q. Jurisdiction to review certain sales of seized property (sec. 6748 of the bill and sec. 6863 of the Code)

Present Law

If the Commissioner makes a jeopardy assessment under section 6861 of the Code and the taxpayer fails to pay the tax upon notice and demand, a lien arises in favor of the United States upon all property, including all after-acquired property, belonging to the taxpayer (sec. 6321). With the lien comes the Commissioner's right administratively to collect the tax by levying upon all property and rights to property belonging to the taxpayer (sec. 6331).

One consequence of a jeopardy assessment is that section 6863(b)(3) generally prevents the Commissioner from selling seized property pending a decision by the Tax Court. Section 6863(b)(3)(b) permits the sale of seized property during the pendency of proceedings in the Tax Court, but only if (1) the taxpayer consents to the sale, (2) the Secretary determines that the expenses of conservation and maintenance will greatly reduce the net proceeds, or (3) the property is of the type described in section 6336, i.e., is liable to perish or become greatly reduced in price or value by keeping, or cannot be kept without great expense. At the present time, the determination of whether one of the exceptions to sale applies is made by the Commissioner. If the taxpayer wishes to contest the sale, the only potential recourse is to bring suit in a United States district court. No forum exists for the Commissioner to request judicial review of the determination to sell seized property.

Reasons for Change

The committee believes that both taxpayers and the IRS will benefit by the opportunity for additional review of the determination to sell seized property.

Explanation of Provision

The bill provides that the Tax Court has jurisdiction during the pendency of the proceedings before it to review the Commissioner's determination to sell seized property under one of the exceptions to the stay of sale provided in section 6863(b)(3)(b). This jurisdiction may be exercised whether the jeopardy assessment was made before or after the petition was filed. The Commissioner will still make the determination that keeping a taxpayer's property would greatly reduce the net proceeds or that the property is of a type described in section 6336, but could obtain review by the Tax Court of that determination. The taxpayer will also be able to obtain Tax Court review of the Commissioner's determination prior to sale, if feasible. Either party may request such review by way of motion. An order of the Tax Court disposing of such a motion is subject to review.

Effective Date

The provision takes effect on the 90th day after the date of enactment.

r. Jurisdiction to redetermine interest on deficiencies (sec. 6749 of the bill and sec. 7481 of the Code)

Present Law

A decision by the Tax Court allows the Commissioner to assess the entire amount redetermined as the deficiency by the Tax Court (sec. 6215(a)). The IRS also collects interest at the statutory rate. The Tax Court does not have jurisdiction to resolve disputes that arise over the Commissioner's interest computation.

Reason for Change

The committee believes that both the taxpayer and the IRS would benefit from permitting the Tax Court to resolve disputes concerning the calculation of interest by the IRS.

Explanation of Provision

The bill provides that if a dispute arises over the Commission's computation of the interest due on the deficiency, then the taxpayer will have one year from the date that the Tax Court decision becomes final in which to move to reopen the Tax Court proceeding for a redetermination of the interest due; however, the taxpayer first must pay the entire deficiency redetermined by the court and the interest determined by the Commissioner. Once entered, an order of the Tax Court redetermining the interest due is appealable in the same manner as a decision of the Tax Court. However, only issues relating to interest (and not issues previously settled, conceded, abandoned, or tried) will be considered by the court of appeals. Finally, nothing in this proposal precludes a taxpayer from contesting in any other forum the Commission's computation of the interest due on the deficiency redetermined by the Tax Court.

Effective Date

The provisions applies to assessments of deficiencies redetermined by the Tax Code made after the date of enactment.

s. Refund jurisdiction for the United States Tax Court (sec. 6750 of the bill and sec. 7442 of the Code)

Present Law

Under present law, when a taxpayer receives a notice from the Commissioner of Internal Revenue that the Commissioner has determined a deficiency of income, estate, gift, or generation-skipping transfer tax, or certain excise taxes, or certain additions to tax, additional amounts, or penalties, the taxpayer may, before paying the determined liability, petition the United States Tax Court for a redetermination of the deficiency within 90 days after the notice of deficiency is mailed (150 days if the notice is addressed to the taxpayer outside the United States). Alternatively, the taxpayer may pay the deficiency and file a claim for refund of the disputed amount with the Internal Revenue Service. If the Service rejects the refund claim (or fails to allow or reject the claim within six months of the date it was filed), then the taxpayer may bring an action against the United States in a United States district court or the United States Claims Court for a judgment that the taxpayer is entitled to a refund of (or credit for) the asserted overpayment. A taxpayer may also file a claim for refund of an overpayment not attributable to a deficiency and, if the refund claim is rejected or not allowed by the Internal Revenue Service within six months of the date the claim was filed, then the taxpayer may bring an action against the United States in a United States district court or the United States Claims Court for a judgment that the taxpayer is entitled to refund of (or credit for) the asserted overpayment. Under present law, the United States Tax Court has no jurisdiction to determine that a taxpayer has made an overpayment except in the context of a deficiency proceeding.

The Tax Court is a single court with nationwide jurisdiction in cases involving certain types of Federal taxes. The Tax Court consists of 19 judges appointed by the President for 15-year terms, and special trial judges appointed by the Chief Judge of the Tax Court. The Tax Court is located in Washington, D.C., but its judges and special trial judges hear cases at locations throughout the United States. The United States district courts are located in each of the States and the geographical scope of a district court is limited to a single Federal district no larger than a single State. Each district court consists of one or more district judges. The United States Claims Court consists of 16 judges appointed by the President for 15-year terms. The Claims Court is a single court with nationwide jurisdiction located in Washington, D.C. The Claims Court may hear cases in Washington, D.C., and in other locations throughout the United States.

The Tax Court's deficiency jurisdiction is limited to income, estate, gift, and generation-skipping transfer taxes, certain excise taxes (relating to certain organizations and persons dealing with them and the windfall profit tax), and certain additions to tax, additional amounts, and penalties. The Tax Court also has certain declaratory judgment jurisdiction regarding tax-exempt organizations, retirement plans, and certain government obligations, as well as jurisdiction over certain disclosure and partnership litigation. In general, the tax Court has no jurisdiction over any case relating to the determination of tax liability, unless it arises from a notice of deficiency. Thus, for example, the Tax Court does not currently have jurisdiction over a refund claim resulting from a carryback of a net operating loss, unless there is a notice of deficiency for the year to which the loss is carried back.

In deficiency proceeding, the Tax Court has jurisdiction to redetermine the correct amount of the deficiency even if the amount so redetermined exceeds the amount determined in the notice of deficiency (but only if the Commissioner of Internal Revenue specifically asks for the increased deficiency). If, in a deficiency proceeding, the Tax Court determines that there is no deficiency, it is further empowered to determine whether the taxpayer has made an overpayment of the tax in issue. The payment of a deficiency by a taxpayer after the mailing of a notice of deficiency does not deprive the Tax Court of jurisdiction over the deficiency.

In a Tax Court deficiency proceedings where the amount of the deficiency in controversy (or the amount of the claimed overpayment) does not exceed $10,000, the taxpayer may elect to have the case heard under a special small tax cases procedure. Decisions in small tax cases are nonprecedential and may not be appealed by either party. Small tax cases are usually tried before Tax Court special trial judges under informal procedures designed to expedite the resolution of the case, as well as to permit the taxpayer to more easily represent himself or herself. The Tax Court special trial judges hear trials of small tax cases at locations in addition to those at which the Tax Court regularly conducts sessions. The district courts and the Claims Court do not have any comparable small tax case procedure.

In a Tax Court deficiency action, the statute of limitations on assessment of tax for the year in issue remains open until the decision of the Tax Court becomes final. The Internal Revenue Service may claim an increased deficiency with respect to the year in issue in the answer in the docketed case, although it bears the burden of proof regarding any such amount. If the statute of limitations on assessment of tax is open regarding a year for which the taxpayer has brought a refund suit in a district court or the Claims Court for that same tax and year, and if the notice of deficiency is mailed before the hearing of the refund action, then the refund action is stayed during the 90-day (or 150-day) period in which the taxpayer may petition the Tax Court with respect to the deficiency, and for 60 days thereafter. If the taxpayer timely petitions the Tax Court, then the refund tribunal loses jurisdiction with respect to that portion of the refund action that is the subject matter of the Tax Court proceeding. If the taxpayer does not timely petition the Tax Court, then the Government may counterclaim for the amount of the asserted deficiency in the pending refund action during the period of the stay or may proceed separately to assess and collect the tax. In the case of such a counterclaim, the taxpayer generally bears the burden of proof regarding the issues raised therein. When the statute of limitations on assessment has run for a year that is the subject of a taxpayer's refund suit, the Government may raise any claim for additional tax due only by way of an offset to reduce or eliminate any refund to which the taxpayer might otherwise be entitled.

Reasons for Change

The Tax Court has played a crucial role in the development of Federal tax law. The Tax Court is a single court with nationwide jurisdiction. It is composed of tax experts devoting their time and attention solely to tax matters. Every opinion issued by the Court is reviewed by the Chief Judge, and when the Chief Judge Determines Court review is appropriate, by the full Court. The Court issues written findings of fact and opinions in most cases it considers, an its opinions usually contain detailed explanations of its reasoning.

The vast majority of Federal tax litigation originates in the Tax Court; at present, more than 80,000 cases are docketed in the Tax Court, compared to fewer than 3,000 tax cases in all of the district courts and the Claims Court combined. Moreover, the Tax Court's focus on tax cases has enabled it to develop streamlined discovery procedures and to emphasize the stipulation process, thus encouraging the efficient disposition of cases. The development of the small tax case procedure has also been a great advantage to many taxpayers who have disputes with the Internal Revenue Service involving relatively modest sums; speedy resolution of the disputes without the necessity of incurring substantial litigation costs contributes to both the perceived fairness and the actual fairness of the tax system. For all of these reasons, the Tax Court is the forum of choice for many taxpayers who have disputes with the Internal Revenue Service, and the opinions of the Tax Court are heavily relied upon by the officials who must administer the law and by the taxpayers and their advisors who must comply with it.

The committee believes that these advantages of Tax Court litigation should be extended to certain refund claims of taxpayers in situations that do not involve the issuance of a notice of deficiency.

The committee believes that including certain refund cases within Tax Court jurisdiction is particularly appropriate at the present time because of changes contained in the Tax Reform Act of 1986, regarding the deductibility of interest on tax deficiencies. Beginning in 1987, interest on tax deficiencies is generally no longer deductible by noncorporate taxpayers; instead, such interest is "personal interest," the deduction of which is disallowed. Although the nondeductibility of personal interest is phased in over five years beginning in 1987, the personal interest disallowance applies without phase-in for purposes of the alternative minimum tax. The nondeductibility of interest on tax deficiencies may encourage many taxpayers to pay asserted tax deficiencies before litigating the merits of their positions. Under section 6213(b)(4), payment of a deficiency after the notice of deficiency is issued does not deprive the Tax Court of jurisdiction over the deficiency (determined without regard to the payment). However, a taxpayer under audit who believes that the Internal Revenue Service will eventually issue a notice of deficiency may want to pay the proposed deficiency immediately to stop the running of interest, the deduction for which is limited or disallowed. If such a taxpayer pays before the notice of deficiency is issued, then he or she will not be able to litigate the position in the Tax Court. If such a taxpayer demands the immediate issuance of the notice of deficiency (and thus fails to exhaust his or her administrative remedies) before paying, then the taxpayer will lose the right to claim reasonable litigation costs under section 7430 and may become subject to the section 6673 penalty (relating to damages for instituting Tax Court proceedings primarily for delay, etc.), although he or she will have preserved his or her right to litigate in the Tax Court. Thus, providing specified refund jurisdiction to the Tax Court will encourage taxpayers wishing to litigate in the Tax Court, who also wish to stop the running of interest on proposed deficiencies, to exhaust their administrative remedies.

Explanation of Provision

The bill amends the Code to provide that the Tax Court has original jurisdiction of tax refund actions against the Secretary of the Treasury involving the same types of taxes and other amounts that are at present included in its deficiency jurisdiction. Although, as under present statutory law regarding Tax Court deficiency proceedings, the Secretary may be named as the adverse party, the committee expects that, as in a deficiency case, the Secretary will delegate to the Commissioner of Internal Revenue the responsibility of appearing for the Secretary as the respondent in Tax Court refund actions. The bill does not change the general prerequisites governing the commencement of tax refund actions. Accordingly, a taxpayer in a Tax Court refund action must pay the tax of which refund is sought in accordance with the full payment rule of *Flora* v. *United States,* 362 U.S. 145 (1960), aff'g on rehearing 357 U.S. 63 (1958), file a proper and timely claim for refund, wait until six months pass or the refund claim is rejected by the Internal Revenue Service, and file a timely and proper pleading seeking the refund in the Tax Court.

Insofar as the limitations prescribed by subchapter B of chapter 66 are concerned, section 6511 will govern in refund proceedings brought in the Tax Court, whereas section 6512 will continue to govern in deficiency proceedings brought in the Tax Court by a taxpayer who also claims to have overpaid his or her taxes.

The committee intends that all issues with respect to the taxes and periods that are the subject matter of a notice of deficiency be resolved in one proceeding either a Tax Court deficiency proceeding or a refund proceeding, at the taxpayer's choice. Accordingly, where the Service has sent a notice of deficiency to a taxpayer, the bill provides that the taxpayer may not bring a Tax Court refund proceeding with respect to the taxes and periods that are the subject matter of the notice of deficiency during the 90-day (or 150-day) period within which the taxpayer is permitted to file a petition with the Tax Court for the redetermination of the deficiency.

The committee further intends that the Service must assert in that proceeding any deficiency with respect to taxes and period that are the subject of a pending Tax Court refund proceeding. Accordingly, the bill provides that if a taxpayer has brought a Tax Court refund proceeding, then further deficiency notices with respect to the taxes and periods that are the subject of the refund proceeding are prohibited. Rather, any additional deficiency must be asserted by the Secretary in an appropriate pleading filed with the Tax Court. Also, as under present law (sec. 6214(b)), the Tax Court could take into account what occured in other years but could not determine tax liability for other years. For example, in an income tax refund proceeding for 1984, the taxpayer's income tax liability for that year might be affected by events occurring in 1983, and the Tax Court could take those events into account, but the Court could not, in the 1984 proceeding, determine whether the taxpayer had a deficiency for 1983. If the Internal Revenue Service wanted to assert an income tax deficiency for 1983, then it would have to follow the existing deficiency procedures route and could not raise the matter by pleading in the 1984 refund proceeding.

The bill extends the small tax case procedures of existing law to the new Tax Court refund action.

The bill provides that execution on a final decision in a Tax Court refund action shall not issue against the Secretary but that any amount payable as a result of such a decision shall be paid out of the proper appropriation by the Treasury Department.

Effective Date

The provision applies with respect to proceedings commenced in the United States Tax Court on or after July 1, 1988.

t. Awarding of costs and certain fees in administrative and civil actions (sec. 6751 of the bill and sec. 7430 of the Code)

Present Law

Code section 7430 authorizes the award of reasonable litigation costs, including attorney's fees and court costs, to a taxpayer who prevails in a tax case in any federal court. Such costs may be awarded whether the action is brought by or against the taxpayer. No award can be made to the government if the taxpayer does not prevail, or to any creditor of a prevailing taxpayer. Section 7430 is the exclusive provision for awards of litigation in any action or proceeding to which it applies.

Section 7430 authorizes an award of reasonable litigation costs only if the taxpayer establishes that the position of the government in the case was not substantially justified and if the taxpayer has substantially prevailed with respect to the amount in controversy or the most significant issue or set of issues presented. The "substantially justified" standard is applicable to prelitigation actions or inaction of the district counsel of the Service (as well as all subsequent administrative action or inaction), a well as the litigation position of the government. Prelitigation actions on inaction by the Service prior to the involvement of district counsel are not eligible as components of any attorney's fee award.

A prevailing party who fails to exhaust administrative remedies or unreasonably protracts the proceedings is not entitled to an award. In addition, no awards may be made to individuals whose net worth exceeds $2 million or, in general, to businesses or organizations, including units of local government, with either a net worth exceeding $7 million or more than 500 employees.

Attorney's fees are awarded based on a maximum rate of compensation of $75 per hour, unless the Court determines that a higher rate is justified.

Reasons for Change

The committee believes that modification of the rules governing awards of litigation costs will ensure that the Government adopts positions that are substantially justified in Federal tax controversies.

Explanation of Provision

The bill shifts the burden of proof with respect to awards of litigation costs to the Government. The Government would be required to prove that its position was substantially justified in order to prevent the taxpayer from recovering. This is consistent with the approach taken under the Equal Access to Justice Act with respect to nontax cases.

The bill permits the recovery of all reasonably litigation costs accruing following the date of the preliminary letter of deficiency. The IRS would be permitted to settle claims for recovery of litigation costs administratively. Administrative decisions concerning such costs would be appealable to the Tax Court under procedures currently applicable to "S" cases.

Effective Date

The provision applies to proceedings commencing after the date of enactment.

u. Civil causes of action for damages against the Goverment and panalty for frivolous suit (secs. 6752 and 6753 of the bill and secs. 7432 and 7433 of the Code)

Present Law

The Federal Tort Claims act expressly provides that it does not apply to "any claim arising in respect of the assessment or collection of any tax." 28 U.S.C. 2680(c). Thus, the Government is not subject to suit for negligent disregard of any provision in the Code or regulations by its officer or employees.

The Code provides specific causes of action against the Government for actions that arise out of the administration of the Federal tax laws. For example, section 7426 permits a person to sue the Government in district court in the case of a wrongful levy or sale of property in which the person claims an interest.

If it appears to the Tax Court that proceedings before it have been instituted or maintained by a taxpayer primarily for delay, that the taxpayer's position in the proceedings is frivolous or groundless, or that the taxpayer has failed to pursue available administrative remedies, the court may award damages to the United States. These damages may not exceed $5,000.

Reasons for Change

The committee believes that additional civil causes of action are warranted to remedy damages arising out of improper administration of the Federal tax law.

Explanation of Provision

The bill provides a taxpayer with the right to sue the Government in district court if any officer or employee of the Service knowingly or by reason of negligence fails to release a lien. The taxpayer would be entitled to recover (1) litigation costs determined under section 7430 plus (2) the greater of actual damages or $100 per day for each day the failure continues to exist following the 30 days after the taxpayer provides written notice of the erroneous lien to the Service.

The bill provides a taxpayer with the right to sue the Government for damages if an employee of the Service carelessly, recklessly, or intentionally disregards any provision in the Code or regulations promulgated thereunder and the issue is ultimately resolved administratively in favor of the taxpayer. The taxpayer would be entitled to recover litigation costs determined under section 7430 plus actual damages unless the taxpayer was contributorily negligent.

The bill permits the district court to impose a panalty of up to $10,000 on a taxpayer for instituting or maintaining a frivolous or groundles suit claiming an unreasonable action by the IRS.

Effective Date

The provision takes effect on the date of enactment.

Present Law

The Privacy Act of 1974 contains a comprehensive system of civil and criminal sanctions directed at protecting the privacy of citizens from government intrusion. However, the Code does not contain a specific proscription concerning IRS investigations of a taxpayer or related compilations of records that are not relevant to the administration or enforcement of the internal revenue laws. Further, the Code does not provide a civil or criminal sanction for knowingly conducting such an investigation or maintaining records containing information obtained in such investigation.

Reasons for Change

The committee believes that additional safeguards are required to protect the privacy of taxpayers subject to IRS investigations.

Explanation of Provision

The bill provides that an employee of the Service shall not knowingly authorize, require, or conduct any investigation of, or surveillance over, any taxpayer that is not connected with the administration or enforcement of the internal revenue laws. Further, it would proscribe the maintenance of records containing information derived from any such investigation or surveillance. This provision is not intended to prevent the Service from continuing to participate with other law enforcement agencies in criminal investigations.

The bill also provides that any person knowingly violating this provision shall be dismissed from employment and, upon conviction, be subject to a fine of up to $10,000, imprisonment for not more than five years, ora both. In addition, such person would be liable for damages. Up to one-half of any criminal fine imposed could, at the court's discretion, be awarded to an informant.

Effective Date

This provision is generally effective on the date of enactment.

w. Assistant Commissioner for Taxpayer Services (sec. 6755 of the bill and sec. 7802 of the Code)

Present Law

There is currently within the Service an Assistant Commissioner (Taxpayer Services and Returns Processing). This position is not provided by statute.

Reasons for Change

The committee believes that it is important to provide statutorily for an IRS manager to be responsible for taxpayer services.

Explanation of Provision

The bill establishes statutorily an Assistant Commissioner for taxpayer services. This bill requires this person (jointly with the Taxpayer Ombudsman) to report annually to Congress concerning the quality of the taxpayer services provided by the IRS.

Effective Date

This provision is effective on the date of enactment.

ESTIMATED BUDGET EFFECTS OF FINANCE COMMITTEE REVENUE PROVISIONS, FISCAL YEARS 1988-90
(Millions of Dollars)

Item	1988	1989	1990	1988-90
Part 1. Revenue Raising Provisions				
A. Accounting Provisions				
1. Completed contract method: Require 100% use of percentage of completion method for all long-term contracts	841	1,556	1,962	4,359
2. Repeal vacation pay reserve	90	120	25	235
3. Installment Sales--repeal for dealers; loosen for nondealers	1,793	2,812	1,992	6,597
4. Amortization of customer base intangibles and similar items	80	115	125	320
B. Estimated Tax Provisions				
1. Mitigation of estimated tax penalties for 1987	-36	--	--	-36
2. Revised withholding certificates required to be put into effect more promptly	(1)	(1)	(1)	(1)
3. Corporate estimated tax reform	1,770	428	329	2,527
C. Corporate Tax Provisions				
1. Modify consolidated return rules to overturn Woods decision	271	415	453	1,139
2. Limitation on consolidated return pass-through	225	380	397	1,002
3. Denial of graduated rates for personal service corporations	75	125	140	340
4. Liquidations of corporate subsidiaries	289	448	572	1,309
5. Regulated Investment Companies	245	37	42	324
D. Partnerships: Portfolio income	77	127	170	374
E. Foreign: Exemption for Eurobond interest through the Netherland Antilles	--	--	--	---
F. Pensions: Modify full-funding limitation (150% rule)	630	1,825	1,420	3,875
G. Estate and Gift Taxes: Freeze of 1987 rates	21	176	232	429
H. Excise Taxes				
1. Telephone Tax: 3-Year Extension	1,305	2,253	2,486	6,044
2. Collect diesel fuel and special motor fuels tax on sales to retailers	208	230	200	638
I. Employment Taxes				
1. Repeal health insurance (Medicare) payroll tax wage base	2,152	6,267	6,916	15,335
2. Increase in railroad retirement tax	144	182	183	509
3. FUTA Tax: 3-year extension of repayment tax; transfer of funds into the Federal unemployment account	711	1,004	1,030	2,745
J. User Fees				
1. Internal Revenue Service	46	60	60	166
2. Extensions and increases in certain alcohol, tobacco, and firearms occupational taxes	105	140	140	385
3. Customs Service	122	152	591	865
K. Debt Collection: 3-Year Extension	300	425	425	1,150
L. Extension of Long-Term Bonds	--	--	--	---
M. Pension Benefit Guaranty Corporation (PBGC) Premiums; Funding (3)	205	201	231	637
Subtotal, Revenue Raisers:	11,669	19,478	20,121	51,268
Part 2. Technical Corrections	1,266	1,539	1,841	4,646
Part 3. Miscellaneous Tax Provisions				
A. Individual Income Tax Provisions				
1. Exemption of mutual fund shareholder expenses from 2% floor on miscellaneous itemized deductions	-282	-296	-354	-932

2. Parent may elect to claim unearned income of dependent on return of parent	(1)	(1)	(1)	(1)
3. Medical expense deduction for certain radon mitigation costs	-1	-3	-4	-8
4. Certain changes in treatment of foster care payments	-3	-1	(1)	-4
5. Treatment of certain amounts paid to or for the benefit of institutions of higher education	(1)	(1)	(1)	(1)
6. Extension of certain nonrecognition of gains rules to Ambassadors and Foreign Service officers	-10	-11	-13	-34
7. Treatment of certain technical personnel	-20	-33	-38	-91
B. Capital Cost Provision: Depreciation of citrus trees	-20	-25	-32	-77
C. Corporate Provisions				
1. NOL carryforwards for thrift institutions	-24	-22	-15	-61
2. Relief from recognition of corporate-level gain involving transfer of residential cooperative units	-3	-4	-4	-11
3. Net operating loss rules for bankruptcy	-1	-1	-1	-3
D. Tax Administration				
1. Disclosure of return information to certain cities	(1)	(1)	(1)	(1)
2. Taxpayer procedures	-315	-240	-245	-800
E. Tax-Exempt Organizations				
1. Certain grants by a foundation deemed to have a charitable purpose	(1)	--	--	(1)
2. Determination of operating foundation status for certain purposes	-1	(1)	(1)	-1
3. Retention of business holdings by certain private foundations	-1	(1)	(1)	-1
F. Excise Taxes and Fees				
1. Application of harbor maintenance tax:				
a. Donated cargo	(1)	(1)	(1)	(1)
b. Hawaii, etc., passenger ship exemption	(1)	(1)	(1)	(1)
2. Definition of manufacturing for the retail truck excise tax	-2	-3	-3	-8
3. Repeal of windfall profit tax	0	0	0	0
4. Customs fee--border companies	(1)	(1)	(1)	(1)
G. Tax-Exempt Bonds				
1. Mortgage revenue bond provisions	-9	-17	-21	-47
2. Arbitrage regulations	(1)	(1)	(1)	(1)
3. Rebate on debt service funds	-3	-5	-5	-13
H. Low-Income Housing Credit	-19	-51	-90	-160
I. Pensions; Employee Benefits				
1. Required beginning date for benefits	(1)	(1)	(1)	(1)
2. Adjustments to limitations on contributions and benefits under qualified plans	(1)	(1)	(1)	(1)
3. No-additional-cost services (air cargo)	-3	-4	-4	-11
4. Section 401(k) plans for rural telephone cooperatives	-1	-4	-4	-9
5. Application of additional income tax on early withdrawals to certain Federal employees	(1)	(1)	(1)	(1)
6. Section 457 not to apply to certain benefits	(1)	(1)	(1)	(1)
7. IRA acquisitions of State-issued coins	(1)	(1)	(1)	(1)
J. Foreign Tax Provisions				
1. Allocation of interest expenses of financial companies	-10	-2	-2	-14
2. Allocation and apportionment of research & experimental expenditures	-389	-630	-691	-1,710
3. Mineral income of foreign sales corporations (FSCs)	-10	-15	-15	-40
4. Aquatic cooperatives: FSCs	-1	-1	-1	-3
K. Minimum Tax Provisions				
1. Exempt structured settlements from AMT earnings & profits preference	--	-20	-25	-45
2. Telephone and electric cooperatives - AMT book preference	-32	-30	-8	-70
3. AMT/Nonconventional fuel credit	-1	-5	-9	-15
4. Extend lot & timeshare installment sales rule to AMT earnings				

and profits preference	--	-5	-7	-12
L. Insurance Provisions				
1. Charitable gift annuities not treated as commercial-type life insurance	--	--	--	---
2. Church self-funded death benefit plans treated as life insurance	-2	-3	-3	-8
M. Accounting Provisions				
1. Funeral trusts	--	--	--	---
2. Reserves for bad debts extended to production credit associations and banks for cooperatives	-39	-17	-18	-74
3. Discharge of indebtedness under toxic waste program	(1)	(1)	(1)	(1)
4. Small bank exception for short-term loans	-176	-11	-10	-197
5. Government grants to SEMATECH not taxable income	-5	(1)	(1)	-5
6. Treatment of gains on ornamental trees	-7	-5	-5	-17
7. Amendments to completed contract method	(1)	(1)	(1)	(1)
8. Special rule for allocation of indebtedness of fiscal year taxpayer	-15	--	--	-15
9. Capitalization rules not to apply to freelance authors & photographers	-28	-8	-3	-39
10. Safe-harbor lease income for rural electric cooperatives	-11	-10	-10	-31
11. Entities may elect taxable year other than required taxable year	30	-15	-15	0
12. Nonrecourse financing on property by savings and loan associations	(1)	-1	-2	-3
Subtotal, Miscellaneous:	-1,414	-1,498	-1,657	-4,569
Grand Totals:	11,521	19,519	20,305	51,345

(1) Loss of less than $500,000.
(2) Gain of less than $500,000.
(3) Estimates provided, which show net effects on the deficit, represent decreased outlays attributable to premium increases and decreased revenues attributable to increased funding requirements. The decreases in outlays are $390 million in fiscal year 1988, $510 million in fiscal year 1989, and $540 million in fiscal year 1990; the reductions in revenues are $185 million in fiscal year 1988, $309 million in fiscal year 1989, and $309 million in fiscal year 1990.

E. Tax-Exempt Organizations

1. Certain grants Deemed to Have a Charitable Purpose (sec. 6761 of the bill and sec. 4945 of the Code)

Present Law

An excise tax is imposed on any taxable expenditure by a private foundation, including any expenditure for a noncharitable purpose (sec. 4945).

Reasons for Change

The committee understands that questions have arisen whether foundation grants awarded prior to 1986 to other charitable organizations which provided technical assistance to individuals seeking to establish local community businesses (and to such businesses) in the area where the foundation carries on its exempt activities should be treated as made for charitable purposes. The committee believes that these grants in past years, which were awarded on good-faith assumptions that the purposes of the grants would be deemed charitable, should not be subject to excise tax liability.

Explanation of Provision

Under the provision, any grant awarded prior to 1986 by a private foundation to another tax-exempt charitable organization for purposes of providing technical assistance to individuals seeking to establish local community businesses (or to such businesses) in the State where the foundation is located is to be treated as made for a charitable purpose.

Effective Date

The provision is effective on the date of enactment.

2. Date for Determination of Operating Foundation status for Certain Purposes (sec. 6762 of the bill and secs. 4940 and 4945 of the Code)

Present Law

Section 302 of the Deficit Reduction Act of 1984 (P.L. 98-369) provided an exemption from the section 4940 excise tax on the net investment income of a private foundation for certain operating foundations. The organizations that were exempted from the tax by that provision included any private foundation that constituted an operating foundation (as defined in sec. 4942(j)(3)) as of January 1, 1983 and that met certain other requirements. The 1984 Act also provided that grants from other foundations to such an operating foundation are not subject to the section 4945 expenditure responsibility requirements.

Reasons for Change

The committee believes that, in light of interpretive questions that have been raised concerning the determination period for operating foundation status with respect to the 1984 Act provision, it is appropriate to provide for this purpose that a foundation that constituted an operating foundation for its last taxable year ending before January 1, 1983 should be treated as constituting an operating foundation as of January 1, 1983.

Explanation of Provision

The bill provides that for purposes of section 302(c)(3) of the Deficit Reduction Act of 1984, a private foundation that constituted an operating foundation (as defined in sec. 4942(j)(3)) for its last taxable year ending before January 1, 1983 shall be treated as constituting an operating foundation as of January 1, 1983.

Effective Date

The provision is effective on enactment.

3. Retention of Business Holdings by Certain Private Foundations (sec. 6763 of the bill and sec. 4943 of the Code)

Present Law

If on May 26, 1969, a private foundation (together with disqualified persons) had business holdings exceeding permitted limitations (generally, 20 percent), the amount of foundation/disqualified person holdings must be reduced in two phases (sec. 4943). In general, a disqualified person is a substantial contributor, or a substantial owner of an entity that is a substantial contributor.

If the 1969 holdings exceeded 95 percent, the foundation has a 20-year period (i.e., until May 26, 1989) to reduce the combined holdings to 50 percent. Within 15 years after the first-phase deadline, the holdings must be reduced, in certain cases, to 35 percent; in addition, the foundation itself may not hold more than 25 percent of the voting stock, dependent on whether disqualified persons own more than two percent.

Reasons for Change

In general, the committee believes that the rationale underlying the excess business holdings rules enacted in 1969 continues to be valid today. In 1969, the Congress was concerned that managers of foundations that owned large holdings in a business tended to be relatively unconcerned about producing income to be used in charitable activities, that their attention and interest would be devoted to the operation, maintenance, and improvement of the business while neglecting exempt activities, and that businesses owned by exempt organizations may be operated in a way that provides those businesses with a competitive advantage over businesses owned by taxable persons. In general, therefore, the Congress concluded that a private foundation should be limited in the amount of a business that it may control.

At the same time, however, the Congress provided in the 1969 Act for continued ownership of certain excess business holdings. The committee believes that it is appropriate to allow further continuation of business holding arrangements that had been established prior to May 26, 1969 if all the additional requirements set forth in the bill are satisfied for such grandfathered holdings.

Explanation of Provision

Under the provision, the 20-year exception for certain excess business holdings acquired prior to May 27, 1969, is made permanent if—

(1) the management of the foundation and the management of the business enterprise are sufficiently unrelated, as specified in the provision;

(2) no disqualified person who was not a foundation manager on October 16, 1987, becomes a foundation manager after that date;

(3) no disqualified person receives compensation (other than reasonable directors fees) from both the foundation and the business enterprise;

(4) the foundation continues to meet the charitable payout rules of present law (sec. 4942); and

(5) the foundation and any disqualified persons comply with the section 4943 rules applicable to any holdings in the enterprise acquired after May 26, 1969.

Effective Date

The provision is effective on enactment.

F. Excise Taxes

1. Application of Harbor Maintenance Tax (sec. 6771)

a. Donated cargo (sec. 6771 of the bill and secs. 4461 and 4462 of the Code)

Present Law

The Water Resources Development Act of 1986 (P.L. 99-662) established a new harbor maintenance user tax of 0.04 percent of the value of the commercial cargo loaded or unloaded at a United States port (sec. 4461), effective on April 1, 1987. Commercial cargo is defined as any cargo transported on a commercial vessel, including passengers transported for compensation or hire.

Under interim regulations issued by the U.S. Customs Service on March 30, 1987, the user tax is assessed on any cargo loaded or unloaded at a U.S. port, unless otherwise exempted. No exception is made in the statute or in the regulations for cargo, usually food, clothing or medical supplies, which is to be donated overseas for humanitarian or developmental reasons.

Reasons for Change

The committee believes that applying the harbor maintenance user tax to cargo that is intended for donation overseas for humanitarian or developmental purposes is inconsistent with the general thrust of the Internal Revenue Code which contains provisions which generally exempt charitable and humanitarian activities from taxation.

Explanation of Provision

The bill excludes from the harbor maintenance tax cargo that is donated for humanitarian and development assistance overseas, where such cargo is owned or financed by a non-profit organization or cooperative.

Effective Date

The provision is effective on the date of enactment.

b. Inclusion of certain passengers in the Hawaii, etc., exemption from the tax (sec. 6771 of the bill and secs. 4461 and 4462 of the Code)

Present Law

The Water Resources Development Act of 1986 (P.L. 99-662) established a harbor maintenance user tax of 0.04 percent of the value of the commercial cargo loaded or unloaded at a United

States port (sec. 4461), effective on April 1, 1987. Commercial cargo is defined as any cargo transported on a commercial vessel, including passengers transported for compensation of hire.

Under interim regulations issued by the Customs Service on March 30, 1987, the user tax is assessed on any cargo loaded or unloaded at a U.S. port, unless otherwise exempted.

Alaska, Hawaii, and insular possessions of the United States were exempted from application of the user tax on cargo, reflecting the evident dependence of these areas upon ocean transportation. The exemption for Alaska and Hawaii refers to cargo instead of commercial cargo to which the general imposition of the user tax is applied. Commercial cargo includes transportation of passengers for compensation or hire. The exemption for cargo with respect to these areas has been interpreted as not referring to passengers.

Reasons for Change

The committee believes that the definition of cargo in the exemption for Alaska, Hawaii and possessions should be corrected to include certain passenger ships, if the passengers are loaded and unloaded in the same State or possession.

Explanation of Provision

The bill amends the exemption from the harbor maintenance user tax for cargo loaded and unloaded in Alaska, Hawaii or a U.S. possession to include certain passengers transported for compensation of hire within the definition of exempted cargo. Passengers loaded in Hawaii or Alaska or a possession will only qualify for the exemption if they are not unloaded in another State or possession or country before being unloaded in the place of loading. In other words, the exemption is intended to cover only intra-State or intra-possession passengers loading and unloading in the same State or possession.

Effective Date

The provision is effective on the date of enactment.

2. Definition of Manufacturing for Retail Excise Tax on Trucks (sec. 6772 of the bill and secs. 4051 of the Code)

Present Law

Section 4051 imposes a 12 percent excise tax on the first retail sale or use after manufacture, production, or importation of any heavy truck, tractor, or trailer. Extensive repairs on a truck or trailer after it has been in use for several years can trigger the tax because the person making the repairs is said to have manufactured a new vehicle.

The committee's attention has been drawn to this matter because the distinction between repairs which are not taxable and manufacturing which is taxable is not always clear to the taxpayer.

As this provision is administered by the Internal Revenue Service, three categories of operations can be performed on a vehicle that can be considered manufacturing. The first category involves making additions of modifications to a chassis or body that so significantly improve or significantly change the transportation function of the chassis or body that they result in the production of a different vehicle. Such modifications or additions are considered as further manufacture of the chassis or body.

The second category involves fabrication of a usable truck from a wrecked vehicle. In this category are repairs to vehicles that are in such a state of disrepair that they have no practical value as motor vehicles.

The third category pertains to repairs of a used vehicle that constitute repair or manufacture that extends the useful life of a vehicle. Only one unambiguous guideline exists, but it is uniquely applicable to the restoration of a milk tank body. However, the guideline—total direct labor and material costs exceed 25 percent of the full retail price of the restored body—is not readily transferable to other vehicles because rigid standards on the manufacture of milk tank bodies also are applied uniformly to restoration operations throughout the country. Such uniform standards are not applicable to other trucks.

Reasons for Change

Of the three tests employed by the IRS to determine whether manufacturing has taken place on a used vehicle, the tests for the first two categories, i.e., changing the transportation function and making a usable vehicle from a wreck, essentially are considered to be clear enough. There is little clarity in the third category, except in the case of the restored milk tank body, of what repairs constitute extension of the useful life of the vehicle.

Explanation of Provision

The bill amends sec. 4052 (a)(1) of the Code so that first retail sale occurs after production, manufacture, or importation. This change reverses the positions of the words "production" and "manufacture".

Furthermore, the committee wishes to clarify that it considers the criteria—the three categories described above—employed to determine whether manufacture of a new truck has occurred to be consistent with the intent of the statute. The committee, however, wishes to emphasize that in cases of the third category, i.e., repair or manufacture that extends the useful life of a vehicle, a higher ratio of repair costs to the full retail price of a comparable new truck should be applied. The committee believes that a ratio of 75 percent is an appropriate safe-harbor, but the IRS will have to administer the criterion with caution so that ordinary repairs to a two or three year old vehicle are not treated as having extended its useful life. On the other hand, the committee wants to leave no doubt that the provisions of sec. 4051(b) apply in the case of a vehicle that has been repaired. In applying this section, the IRS is to aggregate the costs of non-emergency repairs, modifications, or upgrades to a vehicle over any 6 month period, and to use the total value of such repairs in determining whether the 75 percent test is met.

Effective Date

This provision is effective on the date of enactment.

3. Repeal of Windfall Profit Tax (sec. 6773 of the bill and sec. 4986 of the Code)

Present Law

An excise tax is imposed on the windfall profit element of the price of domestically produced crude oil when it is removed from the premises on which it was produced. The windfall profit is defined as the excess of the sale price over the sum of the adjusted base price plus the applicable State severance tax adjustment. The tax rates and recent base prices applicable to taxable crude oil are as follows:

Category of oil	Tax rate (percent)	Base price [1] (per barrel)
Tier-1 Oil (oil not in tiers 2 or 3):		
Integrated producer	70	$18.84
Independent producer	50	19.44
Tier-2 Oil (stripper and petroleum reserve):		
Integrated producer	60	21.99
Independent producer [2]	30	NA
Tier-3 Oil:		
Newly discovered oil [3]	22.5	28.54
Incremental tertiary oil	30	28.07
Heavy oil	30	23.91

[1] Estimate for third quarter of 1987.
[2] Independent producer stripper well oil is exempt from tax.
[3] Rate phases down to 20 and 15 percent in 1988 and 1989.

The tax is scheduled to phase out over a 33-month period beginning no later than January 1991.

Reasons for Change

The committee is concerned that the windfall profit tax discourages exploration for and development of petroleum reserves and thus contributes to the growing petroleum import dependence of the United States documented in March 1987 Department of Energy report on energy security. The committee concurs with the President's May 6, 1987 message to Congress that repeals of the windfall profit tax is necessary to increase U.S. energy and national security.

The committee believes that imposition of a special tax on a single industry, such as the windfall profit tax, is inconsistent with the objectives of the Tax Reform Act of 1986. Moreover, as a result of the sudden drop in oil prices in 1986, the windfall profit tax has outlived its usefulness since, in the committee's view, there no longer are any "windfall profits." Finally, the committee believes that it is unlikely that oil prices will rebound enough for the windfall profit tax to generate significant revenues in the future.

Explanation of Provisions

Under the bill, the windfall profit tax would be repealed.

Effective Date

The provision would apply to crude oil removed from the premises on or after the date of enactment.

4. Customs Fee—Border Companies (sec. 6774 of the bill and 19 U.S.C. 58c(b)

Present Law

As enacted in the Omnibus Budget Reconciliation Act of 1986, an *ad valorem* user fee is applied to all formal entries of merchandise imported for consumption in the amount of 0.22 percent during 1987, dropping to the lesser or 0.17 percent or the rate which will provide revenue equal to the appropriated level of the Customs Service's commercial operations in fiscal year 1988, and expiring after September 30, 1989.

Reasons for Change

The committee believes that it is necessary to remove an inequity that has developed with respect to manufacturing facilities located astride the United States border with another country. In this type of case, user fees have been charged for intracompany transfers of merchandise produced within the manufacturing facilities.

Explanation of Provision

The bill establishes that intracompany transfers of goods within existing company premises straddling a U.S. border with another country would be exempt from the customs user fee provisions, as long as the goods are wholly produced on the premises. For example, a papermaking facility located on either side of the U.S.-Canada border might produce steam and pulp on the Canadian side of the border that is then shipped to the U.S. side of the facility to be used to make paper. As long as such a facility is in existence on the date of enactment and the goods are entirely produced within the facility, as the steam and pulp are, no user fee would be charged in connection with the transfer.

Effective Date

The provision is effective on the date of enactment.

G. Tax-Exempt Bonds

1. Calculation of Income Limits for Qualified Mortgage Bond Financed Housing in Areas with High Housing Costs (sec. 6781 of the bill and sec. 143(f) of the Code)

Present Law

Interest on State or local government bonds generally is tax-exempt (sec. 103). Interest on private activity bonds is tax-exempt only if the bonds are issued for a purpose specifically described in the Code (sec. 141). Issuance of qualified mortgage bonds to finance owner-occupied housing for certain first-time homebuyer is an authorized purpose for private activity tax-exempt bonds. In general, an issue is a qualified mortgage revenue bond only if all owner-financing provided under the issue is provided to mortgagors whose family income is 115 percent or less of the area median gross income (sec. 143(f)).

Reasons for Change

The committee recognizes that the existing income targeting limits may be difficult to apply in areas where the costs of building, operating, and maintaining housing are substantially higher than the national average. The committee feels that this problem is narrow in scope, but wants to provide some relief for those few areas where it does arise.

Explanation of Provision

The provision provides relief to issuers making qualified mortgage bond financed loans in those areas identified as high housing cost areas by defining the income limit to be the greater of 115 percent of area median gross income or that income required to qualify for a mortgage loan for a home with a purchase price not exceeding the purchase price permitted under the Code, using customary and reasonable mortgage lending standards.

To be a high housing cost area, an area must meet four tests. First, it must be identified by the Department of Commerce as a Metropolitan Statistical Area (MSA) or a Primary Metropolitan Statistical Area (PMSA). Second, the MSA or PMSA must have a population in excess of 250,000. Third, the area must have the ratio of its average area purchase price for both new homes and existing homes to the national average purchase price for such homes be greater than 120 percent. Fourth, the area must have the ratio of its average area purchase price for both new homes and existing homes to the State-wide average purchase price for such homes to be greater than 120 percent. The determination of an area's ratio to both national and State-wide averages is to be made separately for existing housing and for new housing, as provided under the present qualified mortgage bond purchase price limits (sec. 143(e)(3)) rather than being determined as an average of the two. Similarly, as indicated in the definition of high cost area, an area qualifies only if both the new home and existing home prices in the area are above the 120 percent threshold.

All national and state averages are computed as simple arithmetic averages of the Average Area Purchase Price Safe Harbor Limitations as defined in Internal Revenue Service published purchase price safe-harbor listings. (*See,* Rev. Proc. 85-42, 1985-2 C.B. 496, and any successor safe-harbor list issued by IRS.) For example, the national average new and existing house prices in Rev. Proc. 85-42 are $96,000 and $86,000. For the State of New York the new and existing average house prices are $97,600 and $82,286. The safe harbor limitations for the New York City PMSA are $129,400 for new houses and $137,200 for existing housing. The applicable ratios for New York City are 134.8, 159.5, 132.6, and 166.7. Thus New York City would qualify as a high housing cost area under this Revenue Procedure.

Effective Date

This provision applies to bonds issued after December 31, 1987, and to bond authority elected to be exchanged for authority to issue mortgage credit certificates after December 31, 1987.

2. Calculation of Qualified Mortgage Bond Purchase Price Limitation for Homes Located on Land Subject to Certain Ground Leases (sec. 6782 of the bill and sec. 143 of the Code)

Present Law

Present law requires that the acquisition cost of residences financed with the proceeds of qualified mortgage bonds be ninety percent or less of the average area purchase price (sec. 143(e)). In determining the acquisition cost where the residence is on land subject to a ground lease, the acquistion cost includes the capitalized value of the lease payments discounted by the yield rate of the issue (Treas. Reg. sec. 6a.103A-2(b)(8)).

Reasons for Change

The committee intends that all States be treated similarly under the qualified mortgage bond provisions. The committee became aware of a Treasury Department regulation which does not permit the capitalization of ground leases in those cases when the lease payment is not specified for the entire term of the lease. Because of historical patterns in some locations, the rent term, while extending for a period of several years, may not be fixed for the entire term of the lease.

Explanation of Provision

The bill directs the Treasury Department to amend its regulations to provide a method of determining a capitalized value of a ground lease for those cases in which the lease has at least thirty-five years remaining and the ground rent is known for at least the first ten years of the remaining lease term. Under the amended regulations, the capitalized value of the ground lease is to be calculated by assigning the current ground lease payment to each year for which the lease does not presently specify a rental payment. These assigned values and the known rental values are to be discounted using a discount rate of three percent, or other rate that the Treasury establishes, and summed. The resulting sum shall serve as the capitalized value of the ground lease.

Effective Date

The amendments to the Treasury regulations required by this provision are to be effective on the day after the date of the bill's enactment. If the regulations are not amended by that date, they are to be deemed to include the provision described above.

3. Treasury Department Regulations Governing Sizing of Tax and Revenue Anticipation Notes (TRANs) (sec. 6783 of the bill and sec. 148 of the Code)

Present Law

Arbitrage profits on investments unrelated to the governmental purpose of tax-exempt bonds must be rebated to the Federal Government unless the gross proceeds of the issue are spent for that governmental purpose within six months after the bonds are issued (Code sec. 148). The amount required to be paid generally is paid on an issue-by-issue basis. A special safe-harbor is provided for tax and revenue anticipation notes (TRANs). Under this safe-harbor, if during the six-month period after the issue date, the cumulative cash-flow deficit of the governmental unit issuing the TRANs exceeds 90 percent of the proceeds of the issue, all net proceeds of the TRAN issue (and any earnings thereon) are deemed to have been spent for the purpose of the issue. TRAN proceeds are treated as spent for the purpose of the borrowing only after all other available funds of the governmental unit have been spent. The Treasury Department has regulatory authority to determine whether other funds of a governmental unit, including funds the use of which is restricted, are available.

Reasons for Change

The committee determined that an amendment is necessary to alleviate uncertainty that has arisen as a result of delay in adoption of regulations by the Treasury Department regarding when funds of a governmental unit are available for purposes of the TRAN rebate safe-harbor exception.

Explanation of Provision

The bill provides that Treasury Department regulations relating to the determination of when funds are available for purposes of the TRAN safe-harbor should not be adopted as temporary regulations. Rather, these regulations should first be issued as proposed regulations and then become effectively only after a Treasury Decision adopts the rules as final regulations.

The committee intends that Treasury is to design these regulations to preclude the creation or enlargement of cash flow deficits by artificially restricting money in special accounts or trusts to enable issuance of TRANs while investing other funds of the issuer for arbitrage profit. The regulations should not, however, require any single method of accounting for all governmental units where differing financial requirements of various governmental units may render accounting variations appropriate and consistent with the objective of limiting TRAN issuance to actual, as opposed to overstated, cash flow deficits.

Effective Date

This provision is effective as if included in the Tax Reform Act of 1986.

4. Arbitrage Rebate Exemption for Certain Bona Fide Debt Service Funds (sec. 6784 of the bill and sec. 148 of the Code)

Present Law

Interest on State and local government bonds generally is tax-exempt (Code sec. 103). Interest on private activity bonds is taxable unless the purpose for which the bonds are issued is specifically allowed under the Code.

Present law restricts the earning of arbitrage profits with respect to tax-exempt bonds (sec. 148). Different restrictions apply with respect to earnings related to the governmental purpose of the borrowing and with respect to earnings from investments unrelated to that purpose. Earnings on nonpurpose investments must be rebated to the Federal Government unless all gross proceeds of the issue are spent for the governmental purpose of the borrowing within six months after the bonds are issued. An exemption applies to earnings on bona fide debt service funds if the gross earnings on the fund do not exceed $100,000.

Reasons for Change

The committee determined that exempting earnings on bona fide debt service funds of governmental units and section 501(c)(3) organizations would make compliance with the rebate requirement by these entities easier while not presenting opportunities for the earning of large amounts of arbitrage profits.

Explanation of Provision

The bill deletes the $100,000 earnings limit for bona fide debt service funds related to bonds that are not private activity bonds and for qualified section 501(c)(3) bonds.

Effective Date

This provision applies to bonds issued after the date of enactment.

H. Low-Income Housing Credit (Sec. 6791–6796 of the Bill and Sec. 42 of the Code)

Present Law

A tax credit payable in annual installments over 10 years is available for qualifying low-income rental housing (Code sec. 42). The credit has a present value of 70 precent of the eligible basis of the property in the case of new construction (other than federally subsidized new construction) and of 30 percent in the case of existing housing and federally subsidized new construction.

Existing housing qualifies for the low-income housing credit only if there has been a period of at least 10 years since the property was last placed in service. This 10-year anti-churning rule may be waived in the case of certain federally subsidized housing where the Secretary of the Treasury determines that mortgage on the housing would otherwise to assigned to the Federal Government or that a Federal insurance claim would result.

Credit cap

Tax credits must be allocated to low-income rental housing projects by State housing agencies. Each State is authorized to allocate annually credits equalling up to $1.25 per resident of the State. Credits generally may only be allocated to rental housing projects that are placed in service in the year of the allocation.

Qualification as credit project

To qualify as a credit project, at least 40 percent of the housing units in the project must be occupied by tenants having incomes of 60 percent or less of the area median income or 20 percent of the housing units must be occupied by tenants having incomes of 50 percent or less of the area median income. A special set-aside election is available for projects where rents charged to low-income tenants does not exceed one-third of the rent charged to other tenants in the project. Rental assistance payments under section 8 of the Housing Act of 1937 are included in determining the amount of rent paid by tenants under the special set-aside rule.

Additionally, gross rent charged to low-income tenants may not exceed 30 percent of the applicable area median income qualifying as low income.

For both of these determinations, qualifying incomes are adjusted to reflect actual family sizes of the tenants.

Recapture

If property on which a low-income housing credit is claimed ceases to qualify as low-income rental housing or is disposed of before the end of a 15-year credit compliance period, a portion of the credits may be recaptured. In the case of a disposition, recapture generally is determined at the level of each owner of the property. In the case of partnerships having more than 35 partners (with no more than 50 percent of the partnership interests being held by corporations), recapture is determined at the partnership level.

Recapture for Change

The committee feels that investors in low-income housing projects need to be provided more flexibility in planning their investments. Often a building may be placed in service before all expenses properly chargeable to the building's capital account are completed. Therefore, the committee feels that such expenditures should not be required to be made before the building is placed in service to be part of the building's eligible basis.

In some metropolitan areas the definition of "area" only includes the central city, while in other metropolitan areas the definition includes the central city and surrounding suburbs. Since incomes typically are higher in surburbs than in the central city, the committee believes that in some cities the present gross income requirement might make projects economically difficult because the targeted income levels would be too low. The committee believes that providing the option of using State gross income will rectify this problem.

Further, the committee determined that certain other liberalizations of the present rules governing the low-income housing credit are appropriate.

Explanation of Provisions

Determination of Eligible Basis

The bill provides that all expenditures properly chargeable to the capital account of a low-income credit building which are incurred within sixty days after the building has been placed in service may be included in the building's eligible basis.

Determination of low-income

The bill provides that the determination of qualifying low income is to be made by reference to the higher of the area median income of the median income of the State in which a credit project is located.

Exceptions to 10-Year Anti-Churning Rule

The bill creates three new exceptions to the 10-year anti-churning rule. First, the bill expands the Treasury Department's authority to grant waivers of this rule to permit such waivers to avert an assignment of a mortgage to a State housing agency (in addition to such an assignment to the Federal Government as presently allowed). Second, the bill permits Treasury to waive the rule in cases where a building is federally insured, but is not federally assisted, if the waiver is to avert the threat of an assignment to the Federal Government or to avert a claim against a Federal insurance fund.

Third, the bill provides an exception to the 10-year anti-churning rule for single-family, owner-occupied housing that has been acquired by a State housing agency through foreclosure and which the State housing agency will convert to low-income rental use. In such cases, as is true under the general provisions of the credit regarding scattered-site housing, each such single family house will be treated as a separate low-income housing credit project. Property eligible for this third exception also is eligible for the credit percentage that applies to new housing, provided that the property never has been held as rental property since originally placed in service.

Recapture for certain partnerships

The bill deletes the limit on corporate ownership for certain large partnerships were credit recapture liability is determined at the partnership, rather than the partner, level.

Transfer of certain partnership interests

The bill provides a special rule pursuant to which low-income rental housing owned by a partnership is treated as sold (and therefore eligible for a credit allocation) if more than 90 percent interests in the partnership are sold in a single transaction. (Under present law, the low-income housing itself must be sold.)

Effective Date

These provisions are effective on January 1, 1988, with respect to property placed in service on or after that date.

I. Pensions; Employee Benefits (Sec. 6801 of the Bill)

1. Required Beginning Date for Benefits (sec. 6801(a) of the bill and sec. 401(a)(9) of the Code)

Present Law

Present law provides (1) a uniform commencement date for benefits under all qualified plans (sec. 401(a) and 403(a)), individual retirement arrangements (IRAs), tax-sheltered annuities and custodial accounts (sec. 403(b)), and eligible deferred compensation plans of State and local governments and tax-exempt employers (sec. 457 plans); and (2) an excise tax sanction for failure to satisfy the minimum distribution rules that apply in lieu of plan disqualification.

Under present law, distributions under all qualified plans, IRAs, tax-sheltered custodial accounts and annuities, and eligible defined compensation plans of State and local governments and tax-exempt employers are required to commence no later than April 1 of the calendar year following the calendar year in which the participant or owner attains age 70½, without regard to the actual date of separation from service.

Reasons for Change

The committee believes that the rules requiring distributions under a qualified plan to begin at age 70½ present unique problems for public employers. State and local governments often have statutory prohibitions that prevent an employee from receiving both salary and retirement income from the employer at the same time (so-called "double dipping" laws).

In addition, often there is a public perception problem in the case of a State or local employer if an employee is receiving both salary and retirement income at the same time.

Finally, a primary purpose underlying the rule requiring distributions at age 70½ is to ensure that distributions from a tax-favored qualified retirement plan are used to fulfill the purpose that justifies their tax-favored status—replacement of a participant's preretirement income stream at retirement—rather than for the indefinite deferral of tax on a participant's accumulation under the plan. The committee does not believe that it is necessary to impose the rule with respect to governmental plans, however, since the type of indefinite deferral that the rule is aimed at curtailing is unlikely to occur in governmental plans.

Explanation of Provision

The bill provides that, in the case of a governmental plan, the required beginning date is the later of (1) the required beginning date under the normal rule or (2) April 1 of the calendar year following the calendar year in which the employee retires.

Effective Date

The provision is effective as if included in section 1121 of the Tax Reform Act of 1986.

2. Adjustments to Limitations on Contributions and Benefits Under Qualified Plans (sec. 6801(b) of the bill and sec. 415 of the Code)

Present Law

In general

Present law (sec. 415) provides overall limits on contributions and benefits under qualified pension, profit-sharing, and stock bonus plans, qualified annuity plans, tax-sheltered annuities, and simplified employee pensions (SEPs). The overall limits apply to all such contributions and benefits provided to an individual by any private or public employer or by certain related employers.

Under a defined contribution plan, the qualification rules limit the annual additions with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) $30,000 (sec. 415(c)). Increased limits (catch-up limits) are provided for certain employees who participate in tax-shaltered annuity programs maintained by specified employers.

Under present law, the limit on the annual benefit provided by a defined benefit pension plan is generally the lesser of (1) 100 percent of average compensation or (2) $90,000.

Beginning in 1988, the $90,000 is scheduled to be adjusted for post-1986 cost-of-living increases. The $30,000 limit on annual additions to a defined contribution plan is scheduled to be adjusted when the dollar limit on annual benefits reaches $120,000.

Early retirement benefits

Under present law, the dollar limit on the annual benefit that may be provided by a qualified defined benefit pension plan ($90,000 for 1987) is reduced if benefits commence before the social security retirement age. The social security retirement age is the age taken into account under the Social Security Act for similar purposes.

The provision does not reduce the 100-percent of compensation limit applicable to annual benefits under a defined benefit pension plan. The reductions provided for benefits commencing between age 62 and the social security retirement age are designed to be consistent with the reductions provided by the Social Security Act for benefits commencing during that period.

For benefits commencing prior to age 62, the limit on the annual benefit is reduced to the actuarial equivalent of the limit applicable at age 62. The actuarial reduction is computed using an assumed interest rate that is not less than the greater of 5 percent or the rate specified in the plan for purposes of determining early retirement benefits.

Special rules

Present law provides special rules applicable to a governmental plan (sec. 414(d)) and to a plan maintained by a nongovernmental organization that is exempt from income.

Under these plans, the actuarial reduction of the limit on annual benefits for early retirement does not reduce the limit below (1) $90,000 for benefits commencing on or after the participant has attained age 62, (2) $75,000 for benefits commencing on or after the participant has attained age 55, or (3) the actuarial equivalent of $75,000 commencing at age 55 for benefits commencing before age 55.

In addition, present law provides a special floor on the annual limit on benefits with respect to certain police and firefighters. In the case of a qualified participant, the special rules for governmental plans apply and, in addition, the reduction provided for benefits payable before age 62 under prior law is not to reduce the dollar limit on annual benefits below $50,000 at any age. Present law provides that the $50,000 limit is to be adjusted for inflation at the same time and in the same manner provided for the adjustment of the general limit on annual benefits under a defined benefit pension plan (sec. 415(d)).

A qualified participant is a participant in a defined benefit pension plan maintained by a State or political subdivision of a State if the period of service taken into account in determining the participant's benefit under the plan includes at least 20 years of the participant's service as (1) a full-time employee of any police department or fire department that is organized and operated by the State or political subdivision of a State maintaining the plan to provide police protection, firefighting services, or emergency medical services for any area within the jurisdiction of that State or subdivision, or (2) a member of the Armed Forces of the United States.

Pre-1986 limits

Prior to 1982, the dollar limits on contributions and benefits were $45,475 and $136,500, respectively. The Tax Equity and Fiscal Responsibility Act of 1982 lowered these limits to $30,000 and $90,000.

Reasons for Change

The committee is aware that, in several States, the courts have held that the benefit formula of a State or local government plan may not be amended in any way that would reduce the ultimate benefit that the participant would receive under the formula in effect when the participant first became covered by the plan. Because these court decisions are based on the constitutional prohibition against impairment of contracts, contained in both the Federal and State constitutions, the rulings cannot be overturned merely by amending State laws or even State constitutions.

The committee believes that governmental plans should comply wth the limits on contributions and benefits applicable to qualified plans in the same manner as plans maintained by private employers. However, the committee is aware that, at least with respect to employees already covered under plans maintained by a State or local government, a State or local government may be forced to violate the limits in order to satisfy constitutional prohibitions on impairment of contract.

Therefore, the committee finds it appropriate to provide temporary relief from the limits on contributions and benefits applicable to qualified plans in the case of certain plans maintained by a State or local government.

Explanation of Provision

Under the bill, a special rule is provided for State and local government plans. Under this special rule, in the case of a plan maintained for its employees by any State or political subdivision, or any agency or instrumentality of a State or political subdivision, the limitation on benefits under a defined benefit pension plan with respect to a qualified participant will be the greater of (1) the limitation normally applicable to benefits under a defined benefit pension plan, or (2) the accrued benefit of the participant under the plan determined without regard to any benefit increases pursuant to a plan amendment adopted after October 14, 1987.

The bill defines a qualified participant as a participant who first became a participant in the plan maintained by the employer before January 1, 1989. The committee intends that a former participant who returns to employment after December 31, 1988, will be treated as a qualified participant if the participant is entitled to credit for such prior service under the rules of section 411(a).

Under the bill, the special rule for State and local governments does not apply unless the employer maintaining the plan elects, at such time and in such manner as the Secretary may prescribe, to follow the rules of section 415 without regard to the special actuarial reductions applicable to public plans, but with regard to the special rules for police and firefighters. Accordingly, under the bill, a public employer is required to elect before the close of the first plan year beginning after December 31, 1988, to apply the rules of section 415 applicable to all employers in order for the special rule to apply.

An employer is not required to make an election prior to the close of the first plan year beginning after December 31, 1988. However, if the employer makes an election for an earlier year, the election must be made before the close of the plan year for which the election is effective. The effect of such an earlier election is to ensure that any employees who first become participants for the plan year for which the election is made will be subject to the general rules of section 415 applicable to all employers and not the special rules for governmental plans (other than the special rules for police and firefighters).

Effective Date

The provision is effective with respect to years beginning after December 31, 1982. The election for general application of the section 415 limits is not required for any year beginning before January 1, 1989.

3. No-Additional-Cost Services (Air Cargo) (sec. 6801(c) of the bill and sec. 132 of the Code)

Present Law

Under present law, no-additional-cost service provided to an employee is not included in the employee's gross income (sec. 132). A no-additional-cost service is any service provided by an employer to an employee for use by such employee if—

(1) such service is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services, and

(2) the employer incurs no substantial additional cost (including foregone revenue) in providing such service to the employee (determined without regard to any amount paid by the employee for such service) (sec. 132(b)).

Reasons for Change

The committee believes that air cargo businesses should be able to provide air travel to their employees as a no-additional-cost service.

Explanation of Provision

Under the bill, the transportation of cargo by air and the transportation of passengers by air are treated as the same service for purposes of section 132(b). Thus, an employee performing services in the air cargo line of business may receive air travel as a no-additional-cost service.

Effective Date

This provision is effective January 1, 1985.

4. Section 401(k) Plans for Rural Telephone Cooperatives (sec. 6801(d) of the bill and sec. 401(k) of the Code)

Present Law

Under present law, in general, State and local governments and other tax-exempt organizations may not maintain qualified cash or deferred arrangements. However, this rule does not apply to rural electric cooperatives.

Reasons for Change

The committee believes that rural telephone cooperatives should also be entitled to maintain qualified cash or deferred arrangements.

Explanation of Provision

Under the bill, the prohibition on State and local governments and tax-exempt organizations maintaining qualified cash or deferred arrangements does not apply to arrangements maintained by rural telephone cooperatives.

Effective Date

This provision applies to years beginning after December 31, 1986.

5. Application of Additional Income Tax on Early Withdrawals to Certain Federal Employees (sec. 6801(e) of the bill and sec. 72(t) of the Code)

Present Law

Present law provides an additional income tax on early distributions from an IRA and from any qualified retirement plan, subject to certain exceptions.

Under present law, the additional income tax on early withdrawals applies to certain distributions from any "qualified retirement plan." Thus, the tax applies to amounts distributed from plans qualified under section 401(a) and 403(a) of the Code, tax-sheltered annuities and custodial accounts, and IRAs, but does not apply to amounts distributed from eligible deferred compensation plans of tax-exempt employers or State or local governments (sec. 457 plans). The rate of the tax is 10 percent for all early distributions includible in gross income, regardless of the character of the contribution (such as income on after-tax employee contributions) to which the distribution relates.

Under present law, the additional income tax on early distributions does not apply to the following distributions: (1) a distribution that is part of a scheduled series of substantially equal periodic payments for the life or life expectancy of the participant (or the joint lives or life expectancies of the participant and the participant's beneficiary); (2) a distribution to an employee who has attained age 55 and subsequently separated from service; (3) a distribution made to an employee to the extent such distribution does not exceed the expenses deductible under section 213 for the year (determined without regard to whether the taxpayer itemizes deductions; and (4) distribution after the death of the employee.

Under present law, certain Federal employees are permitted or requried to retire before age 55. For example, air traffic controllers are required to retire at age 50.

Reasons for Change

The committee believes that it is inequitable to apply the additional income tax on early withdrawals in the case of certain Federal employees who are permitted or required to retire before age 55.

Explanation of Provision

The bill provides that the additional income tax on early withdrawals does not apply in the case of any distribution from a plan maintained by the Federal government (or any agency or instrumentality thereof) that is (1) received by an employee of the Federal government on or after retirement under the plan, and (2) the employee retires on or after attaining age 50.

Effective Date

The provision is effective as if included in section 1123 of the Tax Reform Act of 1986.

6. Eligible Deferred Compensation Plans (sec. 6801(f) of the bill and sec. 457 of the Code)

Present Law

Under present law, unfunded deferred compensation that is provided by a State or local government or by a nongovernmental tax-exempt organization is subject to certain special rules (sec. 457). Under these special rules, the treatment of unfunded deferred compensation depends on whether the deferred compensation is provided under an eligible deferred compensation plan. To qualify as an eligible deferred compensation plan, a plan is required to satisfy certain requirements with respect to, for example, the maximum amount of deferrals that may be made by any participant in any year.

Unfunded deferred compensation provided under an eligible deferred compensation plan is includible in the income of the individual performing services (or his or her beneficiary) in the year in which it is paid or made available. On the other hand, with respect to any State or local government or nongovernmental tax-exempt organization, any unfunded deferred compensation not provided under an eligible deferred compensation plan is includible in income when and to the extent that it is not subject to a substantial risk of forfeiture.

Reasons for Change

The committee believes that the restrictions under section 457 on unfunded deferred compensation should not apply to bona fide vacation pay, sick pay, compensatory time, severance pay, disability pay, and death benefit plans. Although in certain circumstances such plans may provide deferred compensation, the amount of deferred compensation is typically small. Moreover, the plans usually are broad-based, covering low- and middle-income employees as well as highly compensated employees.

Explanation of Provision

The bill exempts from section 457 bona fide vacation pay, sick pay, compensatory time, severance pay, disability pay, and death benefit plans. The committee intends that the Secretary prescribe rules to prevent use of this exemption to provide substantial unfunded deferred compensation. Thus, for example, the Secretary might provide that the aggregate deferrals with respect to an individual under all such plans in any year may not exceed the lesser of (1) 2 months of current compensation, or (2) 12 months of current compensation when combined with all amounts that were previously deferred under all such plans, but have not yet been paid.

Under the bill, amounts that are exempt from section 457 are disregarded in determining whether a plan is an eligible deferred compensation plan. Such amounts are also not subject to the rule, applicable to State and local governments and nongovernmental tax-exempt organizations, that includes in income unfunded deferred compensation when it is not subject to a substantial risk of forfeiture, if such unfunded deferred compensation is not provided under an eligible deferred compensation plan. Instead, unfunded deferred compensation that is exempt from section 457 is treated for tax purposes under the general principles of constructive receipt and economic benefit.

Effective Date

This provision is effective for taxable years beginning after December 31, 1978.

7. IRA Acquisitions of State-Issued Coins (sec. 6801(g) of the bill and sec. 408(m) of the Code)

Present Law

Present law provides that the acquisition by an IRA of any collectible is treated as a distribution from the IRA equal to the cost of the collectible and is includible in the IRA owner's income for the year in which the cost is deemed distributed.

The Tax Reform Act of 1986 provided that gold or silver coins issued by the U.S. are not treated as collectibles for purposes of the IRA prohibition on investments in collectibles.

Reasons for Change

The committee believes that IRA investments in coins issued by the U.S. should not be favored over IRA investments in State-issued coins.

Explanation of Provision

The bill provides that State-issued coins are not treated as collectibles for purposes of the IRA prohibition on investments in collectibles.

Effective Date

The provision is effective for coins acquired by an IRA after date of enactment.

J. Foreign Tax Provisions

1. Application of Interest Expenses of Finance Companies (sec. 6811 of the bill and sec. 864 of the Code)

Present Law

While the Act generally requires an affiliated group to be treated as if all members of the group were one taxpayer for purposes of allocating and apportioning interest expense, that general rule does not apply to any financial institution (described in section 581 or 591) if the business of the financial institution is predominantly with persons other than related persons or their customers, and if the financial institution is required by State or Federal law to be operated separately from any other entity which is not a financial institution. A bank to which this exception applies is not treated as a member of the group for applying the Act's general one-taxpayer rule for interest expense allocation and apportionment to other members of the group; instead, that bank and all other banks in the group are treated as one taxpayer (rather than each bank being treated as a separate taxpayer for this purpose).

The technical corrections title of this bill provides that, to the extent provided in regulations, a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956), and any subsidiary of a bank holding company (or of a financial institution described in section 581 or 591) that is predominantly engaged (directly or indirectly) in the active conduct of a banking, financing, or similar business, shall be treated as a financial institution for purposes of the exception that applies in certain cases to financial institutions described in section 581 or 591.

Reasons for Change

The committee believes that the policy embodied in the separate bank group for interest allocation purposes applies equally to other similarly situated taxpayers that are heavily leveraged and that conduct their activities with unrelated persons. Congress adopted the separated bank group because it did not believe that interest incurred by the group should be allocated against income derived from other unrelated activities by other affiliates. Congress held this view only if the assets of the bank group could not be utilized by the other nonbank members. Congress relied in the Act on Federal or State regulation, and on actual business conduct, in order to ensure that the assets of the bank group did not in fact benefit nonbank members. The committee believes that if other nonregulated, highly leveraged entities engaged in similar businesses to those conducted by banks do in fact operate separately from other nonfinancial affiliates, then the interest incurred by those entities should not be allocated against unrelated income derived by other affiliates.

Explanation of Provision

This bill modifies the Act's separate treatment for banks by extending the same treatment to other financial institutions that operate separately from affiliates that are not financial institutions. In determining whether financial institutions operate separately, the bill allows the entity to demonstrate that it is regulated by state or federal law or that it is fact operates separately. In demonstrating actual independence, the bill provides the Secretary the authority to prescribe regulations to prevent the financial institution from making its assets available to nonfinancial affiliates.

Effective Date

The provision is effective as if it had been included in the Act, generally, taxable years beginning after December 31, 1986, subject to transition rules phasing in the Act's interest allocation provisions.

2. Allocation and Apportionment of Research and Experimental Expenditures (sec. 6812 of the bill and news sec. 864(f) of the Code)

Present Law

Foreign tax credit and source rules

All income has either a U.S. source or a foreign source. The foreign tax credit can offset U.S. tax on foreign source taxable income, but not tax on U.S. source taxable income. (This is known as the foreign tax credit limitation.) A shift in the source of income from foreign to U.S. may increase U.S. tax by reducing the foreign tax credit limitation.

In determining foreign source taxable income for purposes of computing the foreign tax credit limitation, and for other tax purposes, Code sections 861-864 require taxpayers to apportion expenses between foreign source income and U.S. source income. A shift in the apportionment of expenses from U.S. to foreign source gross income decreases foreign source taxable income. This decrease may increase U.S. tax by reducing the foreign tax credit limitation.

Research and experimental expenses allocation regulation

Treasury Regulation section 1.861-8 (issued in 1977) sets forth detailed rules for allocating and apportioning several categories of expenses, including deductible research and experimental expenditures ("research expenses"). The regulation provides that research expenses are ordinarily considered definitely related to all gross income reasonably connected with one or more of 32 product categories based on two-digit classifications of the Standard Industrial Classification ("SIC") system. Research expenses are not traced solely to the income generated by the particular product which benefited from the research activity. Instead, these expenses are associated with all the income within the SIC product group in which the product is classified.

The Treasury regulation contemplates that taxpayers will sometimes undertake research solely to meet legal requirements imposed by a particular political entity with respect to improvement or marketing of specific products or processes. In some cases, such research cannot reasonably be expected to generate income (beyond de minimis amounts) outside that political entity's jurisdiction. If so, the associated research expense reduces gross income only from the geographic source that includes that jurisdiction.

After research expenses incurred to meet legal requirements are allocated under the above rule, any remaining research expenses are generally apportioned to foreign source income based on the ratio of total foreign source sales receipts in the SIC product group with which the expenses are identified to the taxpayer's total worldwide sales receipts in the product group (the "sales" or "gross receipts" method). In computing this fraction, sales of a party controlled or uncontrolled by the taxpayer are taken into account if the party can reasonably be expected to benefit from the research expense. However, the regulation provides that a taxpayer using the sales method may first apportion 30 percent of research expense remaining after allocation to meet legal requirements exclusively to income from the geographic source where over half of the taxpayer's research and development is performed.

Thus, for example, a taxpayer which performs 50 percent or more of its research and development in the United States may automatically approtion at least 30 percent of its remaining research expense to U.S. source income. A taxpayer can chose to apportion to the geographic source where research and development is performed a percentage of research expense significantly greater than 30 percent if the taxpayer establishes that the higher percentage is warranted because the research and development is reasonably expected to have a very limited or long-delayed application outside that geographic source.

Alternatively, subject to certain limitations, a taxpayer may elect to apportion its research expense remaining after any allocation to meet legal requirements under one of two optional gross income methods. Under these optional methods, a taxpayer generally apportions its research expense on the basis of relative amounts of gross income from U.S. and foreign sources. If a taxpayer makes an automatic place-of-performance apportionment, the taxpayer may not use an optional gross income method.

The basic limitation on the use of the optional gross income methods is that the respective portions of a taxpayer's research expense apportioned to U.S and foreign source income using these methods could not be less than 50 percent of the respective portions that would be apportioned to each income grouping using a combination of the sales and place-of-performance apportionment methods.

If this 50-percent limitation is satisfied with respect to both income groupings, the taxpayer may apportion the amount of its research expense that remains after allocation under the legal requirements test ratably on the basis of foreign and U.S. gross income. If the 50-percent limitation is not satisfied with respect to one of the income groupings, then the taxpayer apportions to that income grouping 50 percent of the amount of its research expense which would have been apportioned to that income grouping under the sales and place-of-performance methods. A taxpayer electing an optional gross income method may be able then to reduce the amount of its research expense apportioned to foreign source income to as little as one-half of the amount that would be apportioned to foreign source income under the sales method.

For example, consider a taxpayer with $110 of U.S.-performed research expense and equal U.S. and foreign sales. Assume that $10 of the research expense is to meet U.S. legal requirements and is allocated to U.S. source income. Of the remaining $100, 30 percent ($30) was exclusively apportioned to U.S. source income under the automatic place-of-performance rule and the remaining $70 was divided evenly between U.S. and foreign source income, using the sales method. Thus, under this method $35 would be allocated to foreign source income and $75 would be allocated to U.S. source income. Under the optional gross income methods, the $35 of research expense allocated to foreign sources could have been reduced as much as 50 percent, to $17.50. This could have occurred, for example, if the foreign sales were made by a foreign subsidiary that did not repatriate earnings to the U.S. corporation.

The optional gross income methods apply to all of a taxpayer's gross income, not gross income on a product category basis.

Temporary moratorium and Treasury study

The Economic Recovery Tax Act of 1981 (ERTA) provided that, for a taxpayer's first two taxable years beginning after the date of its enactment (August 13, 1981), all research and experimental expenditures (within the meaning of sec. 174) paid or incurred in those years for research activities conducted in the United States were to be allocated or apportioned to income from sources within the United States (sec. 223 of ERTA).

This two-year moratorium was effectively extended for two additional years by the Tax Reform Act of 1984. Under section 126 of the Act, for taxable years beginning generally after August 13, 1983, and on or before August 1, 1985, all of a taxpayer's research and experimental expenditures (within the meaning of sec. 174) attributable to research activities conducted in the United States are to be allocated to sources within the United States for purposes of computing taxable income from U.S. sources and from sources partly within and partly outside the United States.

One reason Congress cited for enacting the original two-year moratorium was that some foreign countries do not allow deductions under their tax laws for expense of research activities conducted in the United States. Taxpayers argued that this disallowance caused U.S.-based research to be disadvantaged. First, U.S.-base research expense is deemed to be allocated to a foreign country which may not recognize that such amount is deductible as an expense. The allocation of this U.S.-based research expense to foreign sources had the effect of reducing the U.S. taxpayer's foreign tax credit. Because those taxpayers could take their deductions if the research occurred in the foreign country, taxpayers argued that there was an incentive to shift their research expenditures to those foreign countries whose laws disallow tax deductions for research activities conducted in the United States but allow tax deductions for research expenditures incurred locally.

Accordingly, Congress concluded that the Treasury Department should study the impact of the allocation of research expenses under the 1977 regulation on U.S.-based research activities and on the availability of the foreign tax credit. Pending the outcome of the study, Congress concluded that expenses should be charged to the cost of generating U.S. source income, whether such research was a direct or indirect cost of producing foreign source income.

On the ground that a reduction in research and development might adversely affect the competitive position of the United States, the 1983 Treasury report recommended the two-year extension of the moratorium that was ultimately enacted by Congress in 1984. The extension was intended to allow Congress to consider futher the result of the Treasury study.

The Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272) extended the moratorium on the application of the research and experimental expenses allocation rules of the 1977 regulation generally for one additional taxable year beginning after August 1, 1985, and on or before August 1, 1986.

The Tax Reform Act of 1986 permitted the moratorium on application of the research expense allocation rules in Treasury Regulation 1.861-8 to expire. However, for taxable years beginning after August 1, 1986, and on or before August 1, 1987, application of the regulation was liberalized by the Act in three respects, which were intended by Congress to provide an additional tax incentive to conduct research in the United States while Congress analyzed whether any additional permanent incentive is necessary. In addition, Congress intended that the Treasury Department reexamine its regulations in light of concerns expressed by the tax-writing committees of both Houses of Congress concerning the effect of Federal tax law on U.S.-based research activity. These liberalizations apply without regard to other changes made by the Act in the Code's expense allocation rules.

Under reg. sec. 1.861-8(e)(3)(i)(B), research expenditures are allocated entirely to one geographic source if they are incurred to meet legal requirements imposed with respect to improvement or marketing of specific products or processes and cannot reasonably be expected to generate income (beyond de minimis amounts) outside that geographic source. This rule is unaffected by the Act. The first liberalization under the Act is that for the specified one-year period, the Act provided that 50 percent of all remaining amounts allowable as a deduction for qualified research and experimental expenditures (that is, such expenditures within the meaning of section 174 that are attributable to activities conducted in the United States) may be apportioned to U.S. source income and deducted from such income. The Act thus has the effect of increasing the automatic place-of-performance apportionment percentage for U.S.-based research expense from 30 percent to 50 percent. Under the Act, a taxpayer is able automatically to apportion to U.S. source income 50 percent of its U.S.-based research expense remaining after any allocation of such expense incurred to meet legal requirements.

The Act further provided that, for the specified one-year period, the portion of those amounts allowable as a deduction for qualified research and experimental expenditures that remains after any legal requirements allocations and the 50-percent automatic place-of-performance apportionment are apportioned either on the basic of sales or gross income. Thus, the Act's second effective liberalization of the regulation is to allow the automatic place-of-performance apportionment temporarily to taxpayers who elect to apportion expenses using the optional gross income method, rather than only to taxpayers that use the standard sales method of apportionment. Third, the Act has the effect of temporarily suspending the regulatory rule that prohibits taxpayers from using the optional gross income method to reduce allocation of research expense to foreign source income by more than 50 percent over what the allocation to foreign source income would be under the sales method.

The temporary modifications made by the Act to the research expense allocation rules in Treasury Regulation section 1.861–8 apply for purposes of computing taxable income from U.S. sources and from sources partly within and partly outside the United States. The modifications apply only to the allocation of research and experimental expenditures for the purposes of geographic sourcing of income; the modifications do not apply for other purposes, such as the computation of combined taxable income of a FSC (or DISC) and its related supplier. Also, the modifications do not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of depreciable or depletable property to be used in connection with research or experimentation.

Reasons for Change

In the 6 years since the first temporary moratorium on the 1977 regulation was enacted, Congress, the Treasury Department, and representatives of affected industries have intensely scrutinized the effects of R&D allocation rules on R&D activities.[1] That scrutiny has not resulted in an unambiguous recommendation regarding the appropriateness of either the 1977 regulation or 100 percent allocation of U.S.-based research expenses to U.S. source income. On the one hand, there are those who argue that the moratorium and the 1986 partial moratorium had a beneficial effect on U.S. research activity and on U.S. competitiveness in world-wide markets. On the other hand, there were those whose studies prompt them to conclude otherwise. Furthermore, the tax costs of both the total and the partial moratoria have been significant, and the tax benefits they have bestowed are distributed somewhat arbitrarily among firms. At the same time, these firms have faced a prolonged period of uncertainty as to the R&D allocation rules that will apply in the coming years, making it more difficult for them to predict the after-tax costs of the R&D in which they generally must engage, if at all, over extended future periods.

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[1] *See, e.g., Interaction Between U.S. Tax Policy and Domestic Research and Development: Hearing on S. 58 and S. 716 Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance,* 100th Cong., 1st Sess. (1987).

In April 1987 the Treasury, noting that "we all have a stake in ending [the controversy] as soon as possible,"[2] expressed its view that the appropriate way to balance the concerns of promoting U.S. R&D, on the one hand, and appropriately dividing income tax receipts between the United States and foreign taxing jurisdictions, on the other, is to make the 1986 Act liberalization permanent, while further increasing the automatic place-of-performance apportionment percentage from 50 percent to 67 percent.

For the reasons stated above, the committee agree with the Treasury that the period of uncertainty should come to an end. In addition, the committee believes that the exhaustive analysis and debate of the last 6 years is best resolved by a compromise between the alternatives of 100 percent U.S. allocation (the rule in effect between 1981 and 1986) and a return to the 1977 regulation. The committee has concluded that the compromise chosen represents the best response to a record reflecting substantial arguments for diverse approaches to R&D allocation.

The committee believes that this compromise will improve the competitiveness of American industry. In the committee's view, the certainty and the incentive effect provided by this compromise will strengthen America's research effort and thereby lay the groundwork for future economic growth.

Explanation of Provision

The bill creates a new Code provision, section 864(f), which completely supersedes the 1977 regulation and makes permanent the temporary rules of the 1986 Act governing allocation and apportionment of research and experimental expenditures attributable to activities conducted in the United States (so-called qualified research and experimental expenditures), subject to modifications and clarifications.

New section 864(f) expressly retains the regulatory rule allocating research expenses entirely to one geographic source if they were incurred to meet legal requirements imposed with respect to improvement or marketing of specific products or processes and cannot reasonably be expected to generate income (beyond de minimis amounts) outside that geographic source (new sec. 864(f)(1)(A); *see* Treas. Reg. sec. 1.861-8(e)(3)(i)(B) (superseded)).

Under the bill, 67 percent of qualified research and experimental expenditures remaining to be allocated and apportioned after applying the above legal requirements rule are allocated to U.S. source income. The effect of this rule is to raise the automatic place of performance apportionment percentage rule from 50 percent, applicable under the partial moratorium of the 1986 Act, to 67 percent.

Consistent with the effect of the partial moratorium of the 1986 Act, new section 864(f) directs that the portion of qualified research and experimental expenditures remaining after any legal requirements allocation and the 67-percent automatic place-of-performance opportionment will be apportioned either on the basis of sales or gross income. The provision expressly forbids the Treasury to impose any limitation on apportionment on the basis of gross income related to apportionment on the basis of gross sale (or otherwise). In addition, like the 1986 legislation, new section 864(f) expressly does not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of depreciable or depletable property to be used in connection with research or experimentation.

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[2] *Id* at 84.

As is already true for research expenses under the general expense allocation rules introduced in the 1986 Act (sec. 864(e)), section 864(f) provides generally that allocation and apportionment of research expenses, like other expenses, is to be determined as if all members of the affiliated group (plus any section 936 companies (possessions corporations) that would be eligible to consolidate absent statutory prohibition) were a single corporation. However, sales and gross income from products produced in whole or in part in a possession by a 936 company, and dividends from a 936 company attributable to sales of such products, will not be taken into account under new section 864(f) to the extent that the company is allowed a credit with respect to gross income on those products that is intangible property income.

Where an affiliated group with qualified research and experimental expenitures has a 936 company that has elected the cost sharing method (sec. 936(h)(5)(C)(i)) for computing its intangible property income, its cost sharing amount will be an adjustment to the group's qualified research and experimental expenditures subject to section 864(f). Thus, for example, if a group has a 936 company using cost sharing with respect to its only product and all of the group's research expenses are qualified research and experimental expenditures, then the 936 cost sharing amount attributable to those qualified research and experimental expenditures will be included in the research expenses allocated between the group's U.S. and foreign source income based on the gross income or gross sales of the group.

The bill provides the Treasury with authority to prescribe such regulations as may be necessary to carry out the purposes of the one taxpayer rule and its exceptions regarding 936 companies. In addition to providing the safeguards addressed in the regulations under the general one taxpayer rule of section 864(e), these regulations are to provide for the source of gross income and the allocation and apportionment of deductions to take into account the adjustment to group-allocable qualified research and experimental expenditures to take account of reseach expenses treated as cost sharing amounts under section 936.

Effective Date

The provision applies to taxable years beginning after August 1, 1987.

3. Interaction of Mineral Depletion Allowance and Foreign Sales Corporation Rules (sec. 6813 of the bill and sec. 925 of the Code)

Present Law

A Foreign Sales Corporation (FSC) is exempt from tax on certain income related to exports of U.S. products. In general, the FSC benefit is calculated on the basis of net income from property that is exported. Similarly, the amount of depletion for minerals that can be deducted is limited to a percentage of net income from the property. In certain cases, in a process requiring the use of simultaneous equations, the base on which each benefit can be claimed is first reduced by a deduction representing the other benefit.

Reasons for Change

The committee believes that it is not appropriate both to base the commission that a FSC derives (normally based on net income) on income net of the mineral depletion deduction and to base the mineral depletion deduction (also normally based on pre-depletion deduction net income) on income net of the FSC commission.

Explanation of Provision

The bill provides that, in computing the formula commission owed to a FSC from a related supplier that is based on combined taxable income, the deduction for depletion described in section 611 is not taken into account. In computing the section 611 depletion deduction, by contrast, in the case of a sale in which the combined taxable income method is used to compute FSC income, there is to be no deduction for eight twenty-thirds of the taxable income derived by the FSC from the sale of the property for which the depletion deduction is claimed. Thus, in such a case, there is to be deducted from the base used to compute the depletion deduction fifteen twenty-thirds of the taxable income derived by the FSC from the sale of the property for which the depletion deduction is claimed. This deduction reflects the exemption from tax, at the FSC level, of fifteen twenty-thirds of the FSC's taxable income from this kind of export sale.

Effective Date

This provision is effective for taxable years beginning on or after January 1, 1988.

4. Foreign Sales Corporations for Seafood Cooperatives (sec. 6814 of the bill and sec. 927 of the Code)

Present Law

A Foreign Sales Corporation (FSC) is exempt from tax on certain income related to exports of U.S. products. A series of special rules makes FSC benefits available to any "qualified cooperative," defined as any organization to which part I of subchapter T applies which is engaged in the marketing of agricultural or horticultural products.

Reasons for Change

The committee believed it appropriate to extend to cooperatives engaged in exporting seafood the same FSC benefits available to cooperatives exporting agricultural or horticultural products.

Explanation of Provision

The bill treats seafood cooperatives like agricultural or horticultural cooperatives for purposes of the FSC rules.

Effective Date

This provision is effective for taxable years beginning on or after January 1, 1988.

K. Minimum Tax Provisions (Secs. 6821–6824 of the Bill and Secs. 55–59 of the Code)

Present Law

Taxpayers are subject to an alternative minimum tax payable, in addition to all other tax liabilities, to the extent it exceeds the taxpayer's regular tax. The tax is imposed at a flat rate of 21 percent (20 percent in the case of a corporation) on alternative minimum taxable income in excess of an exemption amount. Alternative minimum taxable income generally is the taxpayer's taxable income, increased or decreased by certain adjustments and preferences.

One-half of the excess pre-tax book income of a corporation over other alternative minimum taxable income is a preference for taxable years beginning in 1987 to 1989. For taxable years beginning after 1989, three-fourth of the excess of adjusted current earnings over other alternative minimum taxable income is a preference.

The adjusted current earnings provision requires the inclusion of the income on any annuity contract (as determined under sec. 72(u)(2) (defining income on the contract)). The adjusted current earnings provision does not incorporate the section 72(u)(3)(C) exception to current inclusion of income on the contract provided under the regular tax for nonnatural persons that are holders of annuity contracts, in the case of annuity contracts that are qualified funding assets in connection with structured settlement arrangements.

Reasons for Change

In reviewing the treatment of annuity contracts under the minimum tax, the committee concluded that income on annuity contracts used as qualified assets to fund payments to a plaintiff should not be treated as part of the adjusted current earnings preference, because the holder of the contract is functioning as a conduit for payments to the plaintiff. Therefore, the committee has added an exception to the inclusion of income on annuity contracts under the adjusted current earnings provision for annuities that are qualified funding assets.

The committee also believes that the patronage dividends of rural electric and telephone cooperatives, like the patronage dividends of other cooperatives, should not be subject to the book income preference.

The nonconventional fuels credit that is disallowed by reason of the minimum tax is not carried to other years, unlike other tax credits that are so disallowed. The committee believes that this is unfair and a carryover is therefore provided.

The committee believes that the treatment of timeshares and residential lots sold on the installment basis should be treated the same for all tax purposes and therefore conforms the tax treatment under the adjusted current earnings preference.

Explanation of Provisions

Structured settlements.—An exception is provided for the inclusion of income on annuity contracts under the adjusted current earnings provision, in the case of an annuity contract that is a qualified funding asset within the meaning of section 130(d), but without regard to whether there is a qualified assignment. Similarly, the bill provides that income on annuity contracts held under a plan described in section 403(a) is excluded from the calculation of the adjusted current earnings preference.

Rural electric and telephone cooperatives.—The patronage dividends of rural and electric cooperatives described in section 1381(a)(2)(C) would not be included in book income.

Nonconventional fuels credit.—The minimum tax credit allowable in future years is increased by the amount of the nonconventional fuels credit not allowed solely by reason of the minimum tax limitation for the year.

Timeshares.—The treatment of installment sales of timeshares and residential lots for purposes of adjusted current earnings will be conformed to the regular tax treatment.

Effective Date

The provisions apply to taxable years beginning after December 31, 1987.

L. Insurance Provisions

1. Charitable Gift Annuities Not Treated as Commercial-Type Insurance (sec. 6831 of the bill and sec. 501(m) of the Code)

Present Law

Organizations providing commercial-type insurance

Present law (sec. 501(c)) specifies various standards that an organization must meet in order to qualify for exemption from Federal income taxation. These standards vary depending on the basis on which the entity is seeking exemption.

Under present law as amended by the Tax Reform Act of 1986 (the 1986 Act), an organization described in section 501(c)(3) and (c)(4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. For this purpose, no substantial part has the meaning given to it under present law applicable to such organizations.

In the case of such a tax-exempt organization, the activity of providing commercial-type insurance is treated as an unrelated trade or business (sec. 513) but, in lieu of the usual tax on unrelated trade or business taxable income, the unrelated trade or business activity is taxed under the rules relating to insurance companies (subchapter L).

For this purpose, commercial-type insurance generally is any insurance of a type provided by commercial insurance companies. Present law provides that the issuance of annuity contracts is treated as providing insurance.

Under present law, commercial-type insurance does not include property or casualty insurance provided directly or through an organization described in section 414(e)(3)(B)(ii) by a church or convention or association of churches for the church, convention, or association. It also does not apply to the provision of retirement or welfare benefits by such organizations directly or indirectly through an organization described in section 414(e)(3)(A) or 414(e)(3)(B)(ii) for the employees of such organizations, or for employees' beneficiaries. This exception is not intended to apply if insurance is provided to persons other than the church or convention or association of churches and their employees.

As a result of the 1986 Act, it is arguably uncertain whether the issuance of charitable gift annuities constitutes commercial-type insurance.

Unrelated trade or business income

In addition, an organization that is otherwise exempt from Federal income tax generally is taxed on any income from a trade or business that is unrelated to the organization's exempt purposes. Specific exclusions from unrelated trade or business taxable income are provided for certain types of income, including rents, royalties, dividends, interest, and certain other income, other than income derived from "debt-financed property."

Present law provides that, for purposes of determining unrelated businessd taxable income, income with respect to debt-financed property is treated as income from an unrelated trade or business. Under present law, an exception applies to the usual rules relating to debt-financed property in the case of an annuity that meets several requirements (sec. 514(c)(5)).

First, the value of the annuity is required to be less than 90 percent of the value of the property received at the time of the exchange. Thus, the purchaser or recipient of the annuity is required to make a partial gift to the issuer of the contract.

Second, the annuity is required to be payable over the lives of no more than two lives in being at the time the contract is issued.

Third, the annuity must be payable under a contract that (1) does not guarantee a minimum or specify a maximum number of payments, and (2) does not provide for any adjustment of the annuity payments to take into account the income received on the property transferred.

The present-law exception to the debt-financed property rules has historically exempted from tax any income resulting from the issuance of charitable gift annuities. A charitable gift annuity is an annuity issued by a tax-exempt organization, frequently an educational institution, in exchange for a charitable contribution by the purchaser. The gift portion of the consideration paid is eligible for a charitable contribution deduction.

Reasons for Change

The amendments in the Tax Reform Act of 1986 relating to tax-exempt organizations engaged in commercial-type insurance activities left unclear the tax treatment of charitable gift annuities. The committee does not believe the Tax Reform Act was intended to alter the prior-law tax treatment of charitable gift annuities and believes that the uncertainty created by the 1986 Act relating to the tax treatment of such annuities should be resolved.

Explanation of Provision

The bill provides that charitable gift annuities are not treated as commercial-type insurance. Under the bill, the term. "charitable gift annuity" means an annuity that (1) is owned by an individual who was entitled to a charitable contribution deduction for the purchase of the annuity, and (2) is described in section 514(c)(5) (determined as if any cash paid to the issuer were property).

Effective Date

The provision is effective as if included in the Tax Reform Act of 1986.

2. Church Self-Insured Death Benefit Plans Treated as Life Insurance (sec. 6832 of the bill and sec. 101 of the Code)

Present Law

Definition of a life insurance contract

Under present law, a life insurance contract is defined as any contract which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternative requirements: (1) a cash value accumulation test or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. Whichever test is chosen, that test must be met for the entire life of the contract in order for the contract to be treated as life insurance for tax purposes.

The term "life insurance contract" does not include that portion of any contract that is treated under State law as providing any annuity benefits other than as a settlement option. However, any life insurance contract that is treated under State law as a single, integrated life insurance contract and that satisfies these tests will be treated for Federal tax purposes as a single contract of life insurance and not as a contract that provides separate life insurance and annuity benefits.

If a life insurance contract does not meet either of the alternative tests under the definiton of a life insurance contract, the income on the contract for any taxable year of the policyholder will be treated as ordinary income received or accrued by the policyholder during that year.

Exclusion for death benefits

Present law generally excludes from a beneficiary's gross income proceeds of death benefits received under a life insurance contract sec. 101(a)) and provides a limited exclusion for other benefits paid by or on behalf of an employer by reason of an employee's death (sec. 101(b)).

Exclusion for group-term life insurance

Under present law, the cost of group-term life insurance purchased by an employer for an employee for a taxable year is included in the employee's gross income to the extent that the cost is greater than the sum of the cost for $50,000 of life insurance plus any contribution made by an employee to the cost of the insurance (sec. 79). The exclusion is conditioned on the satisfaction of certain nondiscrimination requirements.

Under present law, a group-term life insurance contract is required to meet the following conditions: (1) the contract is to provide a general death benefit that is excludable under section 101(a), (2) the contract is provided to a group of employees, (3) the policy is provided directly or indirectly by the employer, and (4) the amount of insurance protection provided to each employee is computed under a formula that precludes individual selection. Further, a group-term life insurance contract may not provide a permanent benefit (such as a cash surrender value).

Reasons for Change

The modifications made in the definition of life insurance in the Deficit Reduction Act of 1984 called into question the income tax exclusion for death benefits that some churches provide for their ministers and lay workers. Many of the church death benefit programs are funded through church pension boards, rather than through the purchase of commercial life insurance contracts.

The committee believes that the exclusion for death benefits should be retained in the case of a self-insured church death benefit program as long as the applicable requirements relating to the definition of a life insurance contract are satisfied, other than the requirement that may apply under some applicable State law that the contract must be issued by an insurance company licensed to do business under the laws of the State. Further, the committee believes that such life insurance programs also should be eligible for the exclusion for group-term life insurance as long as the requirements of section 79 are satisfied.

Explanation of Provision

Under the bill, for purposes of section 101(a), the term "life insurance contracts" includes a plan or arrangement that provides for the payment of benefits by reason of the death of the individuals covered under such plan or arrangement, but only if the plan or arrangement (1) is provided directly by a church for the benefit of its employees and their beneficiaries, by a church plan (as defined in sec. 414(e)(3)(A)), or by a church-controlled organization (within the meaning of sec. 414(e)(3)(B)(ii)), and (2) satisfies the requirements relating to the definition of a life insurance contract (sec. 7702) other than the requirement that the plan or arrangement be a life insurance contract under the applicable law.

In addition, under the bill, the cost of such a life insurance contract is eligible for the exclusion for group-term life insurance provided the requirements of section 79 are otherwise satisfied.

The bill defines the term "church" to mean a church or a convention or association of churches. The term "employee" has the same meaning as for purposes of the rules relating to church pension plans (sec. 414(e)(3)(B)).

Effective Date

The provision is effective as if included in the Deficit Reduction Act of 1984.

M. Accounting Provisions

1. Taxation of Preneed Funeral Trusts (sec. 6841 of the bill and sec. 684 of the Code)

Present Law

The income taxation of a trust depends on whether it is a grantor or nongrantor trust. A nongrantor trust is treated as a separate taxable entity on the income it retains and as a conduit on the income it distributes to its beneficiaries.

A grantor trust is treated as owned by the grantor, who is taxed on its income and is entitled to its deductions. A grantor trust is one in which the grantor retains certain powers or interests in the trust. One such power or interest is the power to revest the title of the trust property in himself (sec. 676).

Reasons for Change

Individuals often contract in advance with funeral homes or cementaries to purchase funeral or burial merchandise or services at death. The purchase price under such contracts is generally between $2,000 and $4,000.

State laws governing these contracts require that sale proceeds be placed in a trust in order to insure that funds are available on the date of the purchaser's death. These trusts often are referred to as "preneed funeral trusts." Generally, the funeral director may commingle proceeds from numerous purchases into one trust so long as he keeps adequate records of the purchasers. The purchaser is usually entitled to cancel the contract and receive back his payments.

The right to receive income earned by the preneed trust varies from State to State. In some States, the income must accumulate in the trust, and if the purchaser cancels the contract, he is entitled to receive the income earned on his payment while held in trust. In others, the income unconditionally belongs to the funeral home, which may withdraw it from the trust as it is earned.

Because of differences in State laws, the income taxation of income earned by preneed funeral trusts is unclear. Some funeral homes assert that the income should be taxed to the trust and that they are taxed only upon distribution. Others claim that the income should be taxed to them as earned and that only distributions of principal are taxable to them when distributed.

Nonetheless, the committee believes that all preneed trusts are properly treated as grantor trusts under present law where the purchaser can revoke the purchase and revest title to the trust property in himself. The committee realizes, however, that treating these trusts as grantor trusts often would place administrative burden on both taxpayers and the Internal Revenue Service, given the large number of purchasers and the small size of the trusts.

Accordingly, the committee believes that a different method of taxing these trusts is appropriate. The committee believes that this method of taxation should result in roughly the same level of taxation as if the purchasers had retained the trust assets and had used the income from them to pay for the funeral services at death. The committee believes that this method of taxation properly measures the incomes of both the purchaser and the funeral home [1] and provides a simple system of taxation that avoids the administrative burdens involved in taxing such trusts as grantor trusts.

Explanation of Provision

The committee bill sets forth exclusive rules governing the taxation of qualified funeral trusts. Such trusts are not subject to rules governing the grantor trusts (secs. 671 et. seq.). Thus, income earned by the preneed funeral trust is taxed to the trust and not the purchasers even though the purchaser has the right to rescind the purchase at any time. Amounts distributed from the preneed funeral trust to purchasers are not subject to the accumulation distribution rules (secs. 665 et. sec.) and, consequently, are not subject to further tax to the purchaser at the time of distribution.

A qualified funeral trust is subject to a flat 15 percent tax on its taxable income, with a personal exemption of $1,000 per year. Generally, the trust's taxable income will be determined in the same manner as in the case of an individual.[2]

A qualified funeral trust is one established by a funeral home to which the only contributions made are amounts paid by, or on behalf of, an individual to pay for the costs of funeral and burial services which the home will provide to such individual. The costs of funeral and burial services include the cost of associated merchandise, such as a coffin or flowers.

A trust is not treated as a qualified funeral trust if more than $5,000 (increased by cost of living adjustments) is contributed to it with respect to any individual. Moreover, each funeral home may have only one qualified funeral trust. Thrusts which are separate under state law may be considered one trust for purposes of this limitation.

Distributions from the preneed trust are not taxable to the person for whom the trust was established. Instead, they are includible in the income of the funeral home as amounts paid for the funeral services.

Effective Date

The provision is effective for amounts paid into preneed funeral trusts pursuant to contracts entered into after the date of enactment. In addition, for taxable years beginning after the date of enactment, funeral homes may elect to apply the provisions of the bill to preneed funeral trusts created pursuant to contracts entered into on or before the date of enactment.

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[1] This system results in the same two levels of taxation that arise when income is earned by the individual and is spent on any personal item.

[2] Because the purchase price of such services is relatively small and because the purchasers of preneed contracts are generally of modest means, the committee believes that a 15 percent rate reasonably approximates their marginal tax rate.

2. Bad Debt Expense of Certain Agricultural Credit Institutions (sec. 6842 of the bill and sec. 585 of the Code)

Present Law

Taxpayers other than commercial banks with assets of $500 million or less and thrift institutions are required to determine bad debt expense using the specific charge-off method.

Reasons for Change

The committee believes that certain agricultural credit institutions essentially are equivalent to commercial banks and should be allowed to determine their bad debt expense in the same manner as commercial banks.

Explanation of Provision

Production credit associations that are chartered pursuant to section 2091 of Title 12 of the United States Code and banks for cooperatives that are chartered pursuant to section 2121 of Title 12 of the United States Code are allowed to determine their bad debt expense in the same manner as if they were commercial banks. In addition any production credit association which prior to December 31, 1986, reorganized under State law into an independent lending organization making loans for agricultural purposes shall be treated as a production credit association. However, such an organization (if if otherwise qualifies) may use the reserve method of determining bad debt expense only with regard to loans made while the organization was a production credit association, before such reorganization.

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

3. Discharge of Indebtedness Income of Certain Farmers (sec. 6843 of the bill and sec. 108(g) of the Code)

Present Law

Under present law, certain taxpayers engaged in the trade or business of farming are eligible to exclude from gross income the amount of income from discharge of indebtedness. In order to qualify under this rule, the discharged indebtedness must have been incurred directly in connection with the operation of a farming business by a taxpayer who satisfies a gross receipts test. The gross receipts test is satisfied if the taxpayer's aggregate gross receipts from farming for the three years preceding the year of the discharge are 50 percent or more of his aggregate gross receipts from all sources for the same period.

If a taxpayer is eligible for this relief, he must reduce tax attributes and basis in assets, and recognizes income to the extent the discharge of indebtedness income exceeds the available attributes and basis.

Reasons for Change

The committee believes that the application of the gross receipts test produces inequitable results in the case of a taxpayer engaged in a farming business whose land is contaminated by toxic waste.

Explanation of Provision

The bill provides that, in the case of loans issued pursuant to a state toxic substance loan program that are discharged, the gross receipts test is applied by reference to the three-year period preceding contamination of the land to which the discharged loan relates, rather than the three-year period preceding the year of the loan discharge.

Effective Date

The provision is effective as included in the Tax Reform Act of 1986.

4. Tax Treatment of Short-Term Loans of Small Banks (sec. 6844 of the bill and secs. 1281 and 1282 of the Code)

Present Law

Required accrual of interest on short-term loans

Under present law, certain taxpayers must accrue as interest computed on a daily basis any acquisition discount and stated interest on short-term obligations (sec. 1281). A short-term obligation is one with a fixed maturity date of not more that one year from the date of issue. Persons subject to the accrual of interest on short-term obligations are accrual basis taxpayers, banks, regulated investment companies, common trust funds, dealers in short-term obligations, taxpayers who designate the short-term obligations as part of a hedge, and certain taxpayers who stripped an obligation.

The required accrual of interest attributable to acquisition discount was effective for obligations acquired after July 18, 1984. However, taxpayers could elect to apply the provision to all short-term obligations owned by the taxpayer for his first taxable year ending after July 18, 1984, in which case the taxpayer was permitted a 5-year spread of the income attributable to the change in accounting method for short-term obligations. The extension of the accrual of stated interest on short-term obligations was effective for obligations acquired after September 27, 1985.[1]

Deferral of interest deduction allocable to short-term obligations

For taxpayers who are not required to accrue interest income on short-term obligations (under sec. 1281), present law defers the deduction of direct interest expense with respect to any short-term obligations until the interest income on such short-term obligations is recognized (sec. 1282).

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[1] Sec. — of the bill would change this date until December 31, 1985.

Reasons for Change

The committee believes that loans made by banks, especially small banks, in the ordinary course of their business are not the type of loans that create the abuses to which the special rules for short-term obligations were addressed. Moreover, under section 448, large banks with average gross receipts of more than $5 million are required to use the accrual method. Accordingly, the committee believes that small banks should be exempt from the special rules applicable to short-term obligations with respect to loans made in the ordinary course of the bank's trade or business.

Explanation of Provisions

The bill exempts loans made by small banks in the ordinary course of the bank's trade or business from the required accrual rules of section 1281 and the interest deferral rules of section 1282. A bank is considered a small bank if its average annual gross receipts for the preceding three years is not more than $5 million.

Effective Date

The provision is effective on loans made after July 18, 1984 (i.e., as if it has been included in the Deficit Reduction Act of 1984 (P.L. 98-369)).

5. Tax Treatment of Federal Grants to SEMATECH (sec. 6845 of the bill and sec. 61 of the Code)

Present Law

Present law does not include a statutory provision defining the circumstances under which grants received from the Federal Government by a nonprofit organization to conduct research for governmental purposes, and not as compensation for services, are excludable from the organization's gross income.

Reasons for Change

The committee believes that it is appropriate to adopt a statutory provision providing that U.S. Government noncompensatory grants to SEMATECH, a nonprofit research and development corporation organized pursuant to the National Cooperative Research Act of 1984, are not includible in SEMATECH's gross income.

Explanation of Provision

The bill provides that U.S. Government noncompensatory grants to SEMATECH are excludable from SEMATECH's gross income.

Effective Date

This provision is effective for grants received after the date of enactment.

6. Capital Gains for Certain Evergreen Trees (sec. 6846 of the bill and secs. 263A and 631 of the Code)

Present Law

Under present law, a taxpayer may elect to treat the cutting of timber as the sale or exchange of timber, thereby allowing the gain to be treated as capital gains for income tax purposes. For purposes of this provision, as well as an provision relating to capitalizing inventory costs, the term "timber" includes evergreen trees which are more than six years old at the time they are severed from their roots and sold for ornamental purposes.

Reasons for Change

The committee is concerned that because the growing period varies in different parts of the country, the present law provision requiring a six-year growing period treats growers differently depending on the area that their trees are grown.

Explanation of Provision

The six-year growing period for capital gains for ornamental trees and for the capitalization provisions relating to ornamental trees is reduced to four years.

Effective Date

The provision applies to taxable years beginning after December 31, 1986.

7. De Minimis Exception from Lookback Method Under Long-term Contract Rules (sec. 6847 of the bill and sec. 460 of the Code)

Present Law

Taxpayers engaged in the production of property under a long-term contract must compute income from the contract under either the percentage of completion method or the percentage of completion-capitalized cost method. Under the percentage of completion method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (1) the gross contract price and (2) the percentage of the contract completed during the taxable year. The percentage of a contract completed during the taxable year is determined by comparing costs incurred with respect to the contract during the year with the estimated total contract costs.

In the taxable year in which a contract reported under the percentage of completion method is completed, a determination is made whether the taxes paid with respect to the contract in each year of the contract were more or less than the amount that would have been paid if gross income had been computted by using the actual gross contract price and the actual total contract costs, rather than the anticipated contract price and costs. Interest must be paid by the taxpayer if, applying this "lookback" method, there is an underpayment by the taxpayer with respect to a taxable year.

Similarly, interest must be paid to the taxpayer by the Internal Revenue Service if there is an overpayment.

Under the percentage of completion-capitalized cost method, the taxpayer must take into account 40 percent of the items with respect to the contract under the percentage of completion method. The remaining 60 percent of the items under the contract must be taken into account under the taxpayer's normal method of accounting (e.g., completed contract method, accrual shipment method).

Reasons for Change

The committee believes that the requirements imposed on taxpayers under the lookback method may, in some circumstances, be unduly burdensome. The committee believes therefore that it is appropriate to provide a de minimis exception to the lookback rule for certain long-term contracts.

Explanation of Provision

The bill exempts a long-term contract from application of the lookback method if the taxpayer expects to complete the contract within two years of the contract commencement date and the gross contract price does not exceed the lesser of $1 million or 1 percent of the taxpayer's average gross receipts for the three taxable years preceding the year the contract was entered into.

Effective Date

The provision is effective as if included in the Tax Reform Act of 1986.

8. Transition Rule for Allocation of Indebtedness for Fiscal Year Taxpayers (sec. 6848 of the bill)

Present Law

The Tax Reform Act of 1986 enacted the proportionate disallowance rule, pursuant to which a pro rata portion of a taxpayer's indebtedness is allocated to, and is treated as a payment on, the installment obligations of the taxpayer. The proportionate disallowance rule is generally effective for taxable years ending after December 31, 1986, with respect to dispositions occurring after February 28, 1986.

Reason for Change

The effective date of the proportionate disallowance rule caused certain fiscal year taxpayers to recognize gain with respect to installment obligations that would not have been recognized by calendar year taxpayers. The committee believes that it is appropriate to provide transition relief to certain fiscal year taxpayers that could have changed to a calendar year without the consent of the Secretary.

Explanation of Provision

This bill contains three special rules that apply to any corporation that may elect to change its annual accounting period without the consent of the Secretary. First, the rate of tax imposed on any increase in taxable income by reason of the proportionate disallowance rule for the first taxable year to which the rule applies is not to exceed 40 percent. Second, one-third of any increase in tax that is attributable to the proportionate disallowance rule is to be taken into account for the first taxable year following the year to which the proportionate disallowance rule first applies and the remaining two-thirds is to be taken into account for the second taxable year following the year to which the proportionate disclosure rule first applies. Finally, any corporation that elected to change its taxable year may revoke the election if, within 80 days after the date of enactment of this provision, the corporation establishes to the satisfaction of the Secretary that such election was made by reason of the enactment of the proportionate disallowance rule.

9. Exemption of Expenses of Free Lance Authors and Photographers from Uniform Capitalization Rules (sec. 6849 of the bill and sec. 263A of the Code)

Present Law

In general, uniform cost capitalization rules apply to the manufacture or construction of all tangible property and to the purchasing and holding property for resale. For this purpose, tangible property includes a film, sound recording, video tape, book, or similar property.

Reasons for Change

The committee believes that the application of the uniform capitalization rules to free lance writers and photographers is unduly burdensome. The bill therefore exempts them from the rules.

Explanation of Provisions

The bill provides that the uniform capitalization rules do not apply to any qualified expense paid or incurred by an individual engaged in the business of being a writer or photographer in connection with such business. The exemption applies only to the individual whose personal efforts create a literary manuscript, musical or dance score, photograph, or photographic negative or transparency. It does not apply to the expenses of a person paid or incurred in his capacity as an employee. A qualified expense does not include any expense related to printing, photographic plates, motion picture films, vedeo tapes, or similar items.

Although the exemption generally applies only to the otherwise deductible expenses of an individual, expenses incurred by a qualified employee-owned corporation that directly relate to the activities of a qualified employee-owner also qualify to the extent they would if incurred directly by the employee-owner. In general, a qualified employee-owner is any photographer or writer who is an employee-owner of the corporation and who (alone or in conjunction with members of his family) owns substantially all of the corporation's stock. For this purpose, the committee intends that "substantially all" be defined as 95 percent or more of the corporation's stock (by value).

Effective Date

The provisions are effective as if included in the Tax Reform Act of 1986.

10. Treatment of Safe-Harbor Leases of Membership Organizations (sec. 6850 of the bill and sec. 277 of the Code)

Present Law

Deductions of membership organizations

In the case of a membership organization which is operated primarily to furnish services or goods to its members, deductions arising from providing such services or goods to its members are allowed only to the extent of income derived from providing such services or goods to its members (sec. 277). In essence, the rule prohibits losses incurred from transactions with members to offset income derived from transactions with nonmembers.

Safe harbor leases

The Economic Recovery Tax Act of 1981 (P.L. 79-34) provided as set of rules that were intended to be a means of transferring tax benefits that are structured in the form of a lease. Under these rules (known as the "safe harbor lease rules"), certain transactions involving tangible personal property were treated as lease for Federal income tax purposes regardless of their nontax economic substance. If the transaction met the safe harbor requirements, the lessor in the agreement was treated as the property owner for Federal income tax purposes and was entitled to cost recovery deductions and investment credits. Under these rules, by entering into a nominal sale and safe-harbor leaseback, a person who acquired and used the property could have, in effect, sold some of the tax benefits associated with the property to a corporation, while retaining all other economic benefits and burdens of ownership. The safe harbor lease rules were repealed by the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248).

Reasons for Change

It has come to the attention of the committee that a number of electricity generating cooperatives which are subject to section 277 have entered into safe harbor lease transactions under which these cooperatives, in effect, sold tax benefits. In such transactions, the cooperative, in form, first sells the property to a corporation in exchange for an interest bearing note and cash equal to all or a portion of the value of the tax benefits from the property and then leases the property back from that corporation for a rental that equals to payment on the note.

Under the form of the transaction, the cooperative has interest income and rental expense from the transaction. The Internal Revenue Service has taken the position that the interest income is income not derived from transactions with members while the rental expense must be allocated between income derived from members and nonmembers. As a result, a cooperative that does most its business with members is treated as receiving amounts of interest income which can be offset only by the relatively small amount rental expense allocable to nonmember business, resulting in significant additional tax liability to the cooperative.

The committee believes that the substance of a safe harbor lease transaction, and not its form, should govern the tax treatment. Consequently, the committee believes that safe harbor lease transactions should not result in higher levels of taxation than would occur if the benefit of the safe harbor lease was made in the form of a grant from the Federal Government. The committee believes, however, that the safe harbor lease should not result in avoidance of taxation by the cooperative of its income from nonmembers. Accordingly, the committee believes that the interest income and the rental expense arising from safe-harbor leases should be allocated between members and nonmember income.

Explanation of Provision

The bill provides that the interest income and rental expense from the sale and leaseback of the property under a safe harbor lease are to be first netted and the difference allocated between members and nonmembers in proportion to the business done with each group.

Effective Date

The provision is effective for all open taxable years.

11. Election of Taxable Year Other than Required Taxable Year (sec. 6851 of the bill and secs. 280H, 444 and 6654A of the Code)

Present Law

Partnerships, S corporations, and personal service corporations are generally required to conform their taxable years to that of their owners, effective for taxable years beginning after December 31, 1986. An exception is made for a partnership, S corporation or personal service corporation that establishes to the satisfaction of the Secretary of the Treasury a business purpose for having a different taxable year.

Reasons for Change

The committee believes that allowing a partnership, S corporation, or personal service corporation to use a taxable year different than that of its owners results in an improper deferral of income by those owners. The committee believes that such deferral can best be addressed by allowing a partnership, S corporation or personal service corporation to elect either to change its taxable year or to eliminate the benefit of such deferral by other statutory means.

Explanation of Provision

In general

The provision provides an election for a partnership, S corporation or personal service corporation that is otherwise required to change its taxable year to retain the taxable year used by the partnership, S corproationd or personal service corporation for its last taxable year beginning in 1986. An election is also provided for such entities to adopt or change to taxable years with limited deferral periods, if such adoption or change does not result in a greater deferral than the year currently in use.

Partners in an electing partnership and shareholders in an electing S corporation are required to maked enhanced estimated tax payments. An electing personal service corporation is limited in the amount of deductions it can take for payments to employee-owners unless certain minimum distributions are made to employee-owners before the end of the calendar year.

Taxable years which may be elected

A partnership, S corporation, or personal service corporation is required to use a taxable year determined by statute or regulation, unless it makes an election under this provision. Generally, a partnership, S corporation or personal service corporation may elect a different taxable year only if such taxable year results in a deferral period not longer than three months. The deferral period is the number of months between the close of the taxable period elected and the close of the taxable year otherwise required (the required taxable year). For example, if a taxable year ending September 30 is elected and a taxable year ending December 31 is otherwise required, the deferral period of the taxable year ending September 30 is three months.

In addition, a partnership, S corporation, or personal service corporation may elect a taxable year under this provision that is the same as the entity's last taxable year beginning in 1986. This election is available only if it is made for the entity's first taxable year beginning after December 31, 1986. Such an election is not required to be made prior to the 90th day after the date of enactment of this Act. In the case of a partnership, S corporation, or personal service corporation changing taxable years, an election is available only if the deferral period of the taxable year elected is not longer than the shorter of three months or the deferral period of the taxable year being changed.

For example, a partnership with a required taxable year ending December 31 had a taxable year ending October 31 for its last taxable year beginning in 1986. The partnerhip may elect to retain the year ending October 31 if it makes such an election for its taxable year beginning November 1, 1987. The partnership may also elect to change to a taxable year ending November 30. The partnership may not elect to change to a taxable year ending September 30, since such a taxable year would have a deferral period of three months, which exceeds the deferral period (two months) of the taxable year that is being changed. If the partnership did not make an election for the taxable year beginning November 1, 1987 and instead adopted the taxable year it was otherwise required to use as of December 31, an election to change taxable years would not be available in the future, as any other taxable year it might elect would have a deferral period in excess of the deferral period of the taxable year being changed (zero months).

A special provision is provided for C corporations that made an election after September 18, 1986 and before January 1, 1987 to be treated as S corporations. If such a former C corporation had a taxable year other than a calendar year at the time of the election to be treated as an S corproation and elected to have a claendar year as its taxable year as an S corporation, it may change to a taxable year that results in a deferral period not longer than the shorter of three months or the deferral period of the taxable year of the C corporation prior to the election to be treated as an S corporation.

The Secretary of the Treasury is directed to prescribe such regulations as may be necessary to carry out these provisions, including but not limited to regulations to prevent a taxpayer from obtaining an elective taxable year that would otherwise not be available through a change in the form of any entity.

Effect of election

1. *Partnerships and S corporations.*—In the case of an electing partnership or S corporation, the partners or shareholders of such electing entity are required to make enhanced estimated tax payments. Enhanced estimated tax payments are due in four equal installments on the dates provided for the installment payments of estimated tax. The enhanced estimated tax payments are due whether or not the partner or S corporation shareholder otherwise is required to make a quarterly installment payment of estimated Federal tax. Failure to make required enhanced estimated tax payments results in the imposition of underpayment penalties in the same manner as if the enhanced estimated tax payments were required payments of estimated income tax.

The amount of the enhanced estimated tax payment for any partner or S corporation shareholder is an amount equal to the product of the applicable percentage multiplied by the highest rate of tax imposed by section 1 plus one percent (36 percent for taxable years beginning in 1987) multiplied by the net base year income of the partner or S corporation shareholder. The applicable percentage is determined by the calendar year in which the applicable election year begins. The applicable election year is the year of the partnership or S corporation for which the election is in effect. The applicable percentage is 25 percent for applicable election years beginning in 1987 and increases by an additional 25 percent each year thereafter, so that the applicable percentage is 100 percent for applicable election years beginning in 1990 or thereafter.

The net base year is the year preceding the applicable election year. The net base year income of a partner or S corporation shareholder with respect to any partnership or S corporation is equal to the sum of (a) the deferral ratio times the taxpayer's distributive share of the partnership or S corporation's net income for the base year, plus (b) the excess (if any) of the deferral ratio times the aggregate amount of applicable payments made by the partnership or S corporation to the taxpayer during the base year over the aggregate amount of such payments made during the deferral period.

The deferral ratio is the number of months in the deferral period divided by the number of months in the partnership's S corporation's taxable year. A partner's distributive share of partnership net income is the amount determined by taking into account the partner's distributive share of items described in sections 702(a) and 704, other than items of credit. An S corporation shareholder's distributive share is the amount determined by taking into account the shareholder's pro rata share of items described in section 1366(a), other than items of credit. In no case may a partner's or S corporation shareholder's distributive share for the purpose of this calculation be less than zero.

Applicable payments are amounts paid or incurred by a partnership or S corporation that are includible in the gross income of the partner or shareholder, other than as part of such partner's or shareholder's distributive share. The amount of such payments made in the deferral period is the amount of such payments made during the fiscal year before the beginning of a required taxable year.

For example, a partnership that has historically used a taxable year ending March 31 that is otherwise required to use the calendar year makes an election to use a taxable year ending March 31, 1988. The deferral ratio for the applicable election year will be 9/12 and the applicable percentage will be 25 percent, since the applicable election year begins in 1987. Assume that a calendar-year partner in such partnership had a distributive share of $100,000 for the year ending March 31, 1987 (the base year) and also received rental payments of $120,000 of which $40,000 was received on August 15, 1986 and $80,000 was received on January 15, 1987. The net base year income of the partner is $125,000 [1] and the enhanced estimated taxes required to be paid by the calendar year partner for his taxable year ending December 31, 1987 are $11,250.[2] This amount is required to be paid by the partner in four equal installments of $2,812.50 on April 15th, June 15th and September 15th of 1987, and on January 15th of 1988.

The inclusion of applicable payments in the calculation is not required if the applicable payments are made ratably throughout the base year. For this purpose, payments will be considered to be made ratably if they are made in equal amounts at least monthly.

A taxpayer is required to make enhanced estimated tax payments for all electing partnerships or S corporations in which such taxpayer owns shares or an interest. However, a taxpayer who is required to make aggregate payments of enhanced estimated taxes for the year of $200 or less is excused from making such payments.

An electing partnership or S corporation is required to compute and disclose to its partners or shareholders the enhanced estimated tax amount for each such partner or shareholder for the applicable election year, as well as any other information the secretary of the Treasury may prescribe to carry out this provision. This does not, however, release the partner or shareholder from any responsibility he may have with regard to the determination of such amount.

2. *Personal service corporations.*—An electing personal service corporation is required to meet minimum distribution requirements in the portion of the applicable election year that constitutes the deferral period.[3] The minimum distribution requirements for

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[1] [(9/12) X 100,000] + {[(9/12 X 120,000] − 40,000}

[2] [.25 X .36 X 125,000]

[3] Since personal service corporations are required to use the calendar year, the deferral period is the portion of the applicable election year before January 1.

any applicable election year are met if applicable amounts paid to employee-owners during the deferral period of the applicable election year equal or exceed the lesser of (a) the product of (i) the applicable amounts paid during the preceding taxable year, divided by the number of months in such year, multiplied by (ii) the number of months in the deferral period or (b) the applicable percentage of the adjusted taxable income of the personal service corporation for the deferral period of the applicable election year. For these purposes, the applicable percentage is the average percentage (not to exceed 95 percent) of the adjusted taxable income of the personal service corporation that was paid out in applicable amounts over the prior three taxable years. Adjusted taxable income is the taxable income for the period increased by any amount paid or incurred to an employee-owner that was taken into account in determining taxable income.

If a personal service corporation fails to meet the minimum distribution requirement for any applicable election year. the amount of applicable payments it may deduct for the applicable election year is limited to a maximum deductible amount. The maximum deductible amount is equal to the sum of (a) the applicable amounts paid in the deferral period plus (b) the applicable amounts paid in the deferral period divided by the number of months in the deferral period multiplied by the number of months not in the deferral period. Any amount paid or incurred by the personal service corporation that would be deductible but for the maximum deduction amount is treated as paid or incurred in the succeeding taxable year.

Tiered structures

The committee is concerned that the use of the election in the case of tiered structures may not yield appropriate results. Accordingly, the elections provided by this provision are not available to an entity that is part of a tiered structure, except as provided in regulations. An example of such a tiered structure would be a calendar year partnership with partners that are personal service corporations with taxable years ending November 30 where the personal service corporations are in turn owned by calendar year individuals. Except as provided in regulations, neither the partnership nor the personal service corporations described would be allowed to use the election provided by this provision.

Effective Date

The provision generally is effective for taxable years beginning after December 31, 1986. The requirement that enhanced estimated taxes be paid by partners and shareholders of electing entities is effective for taxable years beginning after December 31, 1987, with respect to applicable election years beginning after December 31, 1986.

12. Nonrecourse Financing on Property Provided by Savings and Loan Associations (sec. 6852 of the bill and sec. 465 of the Code)

Present Law

Present law provides an at-risk limitation on losses from business and income-producing activities. The rule applies to individuals and to certain closely held corporations. The rule is designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in an activity. The 1986 Act extended the loss limitation at-risk rules (and also the credit at-risk rules) to the activity of holding real property, and provided an exception to the loss limitation at-risk rules for qualified nonrecourse financing which is secured by real property used in the activity. In general under the at-risk rules, seller financing is not treated as an amount at risk. In the case of a real estate activity involving nonrecourse financing from related persons (not including the seller, a person receiving a fee for the investment (such as a promote), or a person related to either of them), the financing can be treated as an amount at risk only if the terms of the loan are commercially reasonable and on substantially the same terms as loans involving unrelated persons.

Reasons for Change

The committee is concerned that savings and loans are unable to sell foreclosed property because of the present law at-risk rules, and that therefore their financial condition is impaired.

Explanation of Provision

The bill provides an exception to the restriction preventing the seller of property from being a qualified lender under the at-risk rules in the case of the sale of foreclosed property by a savings and loan association. Certain requirements must be met for the exception to apply. The financial institution that is the seller of the property and that is providing the financing must have acquired the property by foreclosure. The interest rate on the financing may not be less than the applicable Federal rate (determined under sec. 1274(d)) for the appropriate term at the time the financing is incurred. The amount treated as qualified nonrecourse financing under the exception may not exceed the adjusted basis of the financial institution with respect to the property immediately before the institution sells the property, unless the Secretary determines that under the facts and circumstances a different amount is warranted. The financing is required to be commercially reasonable and on substantially the same terms as loans involving unrelated persons.

Effective Date

The provisions will be effective as if included in section 503 of the Tax Reform Act of 1986.

Estimated Budget Effects of Finance Committee Revenue Provisions, Fiscal Years 1988–90

[Millions of dollars]

Item	1988	1989	1990	1988–90
Part 1. Revenue Raising Provisions				
A. Accounting Provisions:				
1. Completed contract method: Require 100% use of percentage of completion method for all long-term contracts	841	1,556	1,962	4,359
2. Repeal vacation pay reserve	90	120	25	235
3. Installment Sales—repeal for dealers; loosen for nondealers	1,793	2,812	1,992	6,597
4. Amortization of customer base intangibles and similar items	80	115	125	320
B. Estimated Tax Provisions:				
1. Mitigation of estimated tax penalities for 1987	−36			−36
2. Revised withholding certificates required to be put into effect more promptly	(1)	(1)	(1)	(1)
3. Corporate estimated tax reform	1,770	428	329	2,527
C. Corporate Tax Provisions:				
1. Modify consolidated return rules to overturn Woods decision	271	415	453	1,139
2. Limitation on consolidated return pass-through	225	380	397	1,002
3. Denial of graduated rates for personal service corporations	75	125	140	340
4. Liquidations of corporate subsidiaries	289	448	572	1,309
5. Regulated Investment Companies	245	37	42	324
D. Partnerships: Portfolio income	77	127	170	374
E. Foreign: Exemption for Eurobond interest through the Netherland Antilles				
F. Pensions: Modify full-funding limitation (150% rule)	630	1,825	1,420	3,875
G. Estate and Gift Taxes: Freeze of 1987 rates	21	176	232	429

H. Excise Taxes:				
1. Telephone Tax: 3-Year Extension	1,305	2,253	2,486	6,044
2. Collect diesel fuel and special motor fuels tax on sales to retailers	208	230	200	638
I. Employment Taxes:				
1. Repeal health insurance (Medicare) payroll tax wage base	2,152	6,267	6,916	15,335
2. Increase in railroad retirement tax	144	182	183	509
3. FUTA Tax: 3-year extension of repayment tax; transfer of funds into the Federal unemployment account	711	1,004	1,030	2,745
J. User Fees:				
1. Internal Revenue Service	46	60	60	166
2. Extensions and increases in certain alcohol, tobacco, and firearms occupational taxes	105	140	140	385
3. Customs Service	122	152	591	865
K. Debt Collection: 3-Year Extension	300	425	425	1,150
L. Extension of Long-term Bonds:				
M. Pension Benefit Guaranty Corporation (PBGC) Premiums: Funding (3)	205	201	231	637
Subtotal	**11,669**	**19,478**	**20,121**	**51,268**
Part 2. Technical Corrections	**1,266**	**1,539**	**1,841**	**4,646**
Part 3. Miscellaneous tax provisions:				
A. Individual Income Tax Provisions:				
1. Exemption of mutual fund shareholder expenses from 2% floor on miscellaneous itemized deductions	−282	−296	−354	−932
2. Parent may elect to claim unarned income of dependent on return of parent	(1)	(1)	(1)	(1)
3. Medical expense deduction for certain radon mitigation costs	−1	−3	−4	−8
4. Certain changes in treatment of foster care payments	−3	−1	(1)	−4

Estimated Budget Effects of Finance Committee Revenue Provisions, Fiscal Years 1988–90—Continued

[Millions of dollars]

Item	1988	1989	1990	1988–90
5. Treatment of certain amounts paid to or for the benefit of institutions of higher education	(1)	(1)	(1)	(1)
6. Extension of certain nonrecognition of gains rules to Ambassadors and Foreign Service officers	−10	−11	−13	−34
7. treatment of certain technical personnel	−20	−33	−38	−91
B. Capital Cost Provision: Depreciation of citrus trees	−20	−25	−32	−77
C. Corporate Provisions:				
1. NOL carryforwards for thrift institutions	−24	−22	−15	−61
2. Relief from recognition of corporate-level gain involving transfer of residential cooperative units	−3	−4	−4	−11
3. Net operating loss rules for bankruptcy	−1	−1	−1	−3
D. Tax Administration:				
1. Disclosure of return information to certain cities	(1)	(1)	(1)	(1)
2. Taxpayer procedures	−315	−240	−245	−800
E. Tax-Exempt Organizations:				
1. Certain grants by a foundation deemed to have a charitable purpose	(1)			—
2. Determination of operating foundation status for certain purposes	−1	(1)	(1)	−1
3. Retention of business holdings by certain private foundations	−1	(1)	(1)	−1
F. Excise Taxes and Fees:				
1. Application of harbor maintenance tax:				
a. Donated cargo	(1)	(1)	(1)	(1)
b. Hawaii, etc., passenger ship exemption	(1)	(1)	(1)	(1)
2. Definition of manufacturing for the retail truck excise tax	−2	−3	−3	−8

3. Repeal of windfall profit tax	0	0	0	0
4. Customs fee-border companies	(1)	(1)	(1)	(1)
G. Tax-Exempt Bonds:				
1. Mortgage revenue bond provisions	−9	−17	−21	−47
2. Arbitrage regulations	(1)	(1)	(1)	(1)
3. Rebate on debt service funds	−3	−5	−5	−13
H. Low-Income Housing Credit	19	−51	−90	−160
I. Pensions: Employee Benefits:				
1. Required beginning date for benefits	(1)	(1)	(1)	(1)
2. Adjustments to limitations on contributions and benefits under qualified plans	(1)	(1)	(1)	(1)
3. No-additional-cost services (air cargo)	−3	−4	−4	−11
4. Section 401(k) plans for rural telephone cooperatives	−1	−4	−4	−9
5. Application of additional income tax on early withdrawals to certain Federal employees	(1)	(1)	(1)	(1)
6. Section 457 not to apply to certain benefits	(1)	(1)	(1)	(1)
7. IRA acquisitions of State-issued coins	(1)	(1)	(1)	(1)
J. Foreign Tax Provisions:				
1. Allocation of interest expenses of financial companies	−10	−2	−2	−14
2. Allocation and apportionment of research & experimental expenditures	−389	−630	−691	−1,710
3. Mineral income of foreign sales corporations (FSCs)	−10	−15	−15	−40
4. Aquatic cooperatives: FSCs	−1	−1	−1	−3
K. Minimum Tax Provisions:				
1. Exempt structured settlements from AMT earnings & profits preference		−20	−25	−45
2. Telephone and electric cooperatives—AMT book preference	−32	−30	−8	−70
3. AMT/Nonconventional fuel credit	−1	−5	−9	−15
4. Extend lot & timeshare installment sales rule to AMT earnings and profits preference		−5	−7	−12

Estimated Budget Effects of Finance Committee Revenue Provisions, Fiscal Years 1988-90—Continued

[Millions of dollars]

Item	1988	1989	1990	1988-90
L. Insurance Provisions:				
1. Charitable gift annuities not treated as commercial-type life insurance				
2. Church self-funded death benefit plans treated as life insurance	−2	−3	−3	−8
M. Accounting Provisions:				
1. Funeral trusts				
2. Reserves for bad debts extended to production credit associations and banks for cooperatives	−39	−17	−18	−74
3. Discharge of indebtedness under toxic waste program	(1)	(1)	(1)	(1)
4. Small bank exception for short-term loans	−176	−11	−10	−197
5. Government grants to SEMATECH not taxable income	−5	(1)	(1)	−5
6. Treatment of gains on ornamental trees	−7	−5	−5	−17
7. Amendments to completed contract method	(1)	(1)	(1)	(1)

8. Special rule for allocation of indebtedness of fiscal year taxpayer	−15			−15
9. Capitalization rules not to apply to freelance authors & photographers	−28	−8	−3	−39
10. Safe-harbor lease income for rural electric cooperatives	−11	−10	10	−31
11. Entities may elect taxable year other than required taxable year	30	−15	−15	0
12. Nonrecourse financing on property by savings and loan associations	(1)	−1	−2	−3
Subtotal, Miscellaneous	**−1,414**	**−1,498**	**−1,657**	**−4,569**
Grand Total	**11,521**	**19,519**	**20,305**	**51,345**

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[1] Loss of less than $500,000.

[2] Gain of less than $500,000.

[3] Estimates provided, which show net effects on the deficit, represent decreased outlays attributable to premium increases and decreased revenues attributable to increased funding requirements. The decreases in outlays are $390 million in fiscal year 1988, $510 million in fiscal year 1989, and $540 million in fiscal year 1990; the reductions in revenues are $185 million in fiscal year 1988, $309 million in fiscal year 1989, and $309 million in fiscal year 1990.

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Title VII

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United States Senate
COMMITTEE ON
GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510-6250

October 19, 1987

The Honorable Lawton Chiles
Chairman
Committee on the Budget
Washington, D.C. 20510

Dear Mr. Chairman:

In accordance with the reconciliation instructions in the First Concurrent Resolution on the Budget (S. Con. Res. 48) the recommendations of the Governmental Affairs Committee to effect the required budgetary savings are enclosed.

The Committee has adopted language to modify federal civilian pay increases. Also included are improved federal cash management procedures--the amended text of S. 1381, the Cash Management Improvement Act.

Sincerely,

John Glenn
John Glenn
Chairman

Enclosures

COMMITTEE ON GOVERNMENTAL AFFAIRS

CIVILIAN PAY

The Committee has adopted language that legislates a 3 percent pay raise for civilian workers of the federal government for fiscal year 1988, but rounds down the amount of that increase to the nearest dollar per paycheck per employee. In addition, the Committee has approved legislation that makes the date of future pay raises, in fiscal years 1989 and 1990, effective the first pay period after January 1st of each year.

The Committee achieves out-year savings in accordance with the First Concurrent Budget Resolution for Fiscal Year 1988. The legislation does not mandate pay raise levels for fiscal years 1989 and 1990, but rather retains the current process for determining annual increases through the Pay Comparability Act, Presidential alternative pay proposals and subsequent Congressional action. However, any pay proposal must save at least $480 million in FY 1989 and $1,810 million in FY 1990, which is consistent with the recently enacted budget resolution. The estimates are based on the Resolution's baseline pay assumptions of 4.8 percent in 1989 and 5.2 percent in 1990. The Committee notes that these savings could be achieved if FY 1989 and FY 1990 pay raises were approximately 4.8 and 5.2 percent respectively, and employing agencies were required to absorb approximately half of the cost of the pay increases.

CASH MANAGEMENT IMPROVEMENT ACT OF 1987

The Committee has adopted the amended text of S. 1381, the Cash Management Improvement Act, as reported by the Subcommittee on Government Efficiency, Federalism, and the District of Columbia.

REPORT FROM SUBCOMMITTEE

I. PURPOSE AND SUMMARY

In order to maximize the efficiency of Federal cash transactions with the States, Sec. 7002 establishes several procedures and incentives. Their purpose is to minimize the time between the availability and outlay of Federal funds for programs administered by the States.

The short title and purpose are set out in subsections (a) and (b). Subsection (c) authorizes the Secretary of the Treasury to promulgate regulations providing for the timely disbursement of funds by Federal executive agencies. The Secretary is further empowered under this section to assess against a noncomplying agency a penalty equal to the "cost" of such noncompliance, e.g., costs such as those associated with the payment of interest under subsection (d).

Subsection (d) seeks to resolve longstanding differences between the Federal and State governments regarding cash management practices involving the financing of Federal assistance programs. Each side in the debate had occasion to charge that its funds were being used by the other for unduly lengthy periods of time -- either because States drew down Federal funds too far in advance of when they were needed to cover expenditures, or because Federal agencies were slow in reimbursing funds advanced by States for Federal program purposes. Subsection (d) amends the Intergovernmental Cooperation Act (section 6503(a) of title 31). Consistent with the Memoranda of Understanding agreed to in June, 1983 and November, 1985 by the Joint Federal/State Cash Management Reform Task Force, the amended section 6503(a) establishes (1) a set of government-wide cash management policies and practices to govern the exchange of funds between the Federal and State governments and (2) intergovernmental cash management practices which assure that neither the Federal nor a State government either benefits or suffers financially as a result of a cash transfer under a Federal program. The chief mechanism for accomplishing this end is the calculation and setoff of interest between the Federal government and each State government, for the periods when Federal funds are drawn down pending expenditure, or when State funds are advanced pending reimbursement.

Finally, subsection (e) of Section 7002 requires the Secretary of the Treasury to study and report on the feasibility of establishing a national lockbox system for agencies on a government-wide basis, to improve the collection and deposit of Federal funds.

II. BACKGROUND AND NEED FOR LEGISLATION

The amount of funds transferred to state and local governments, to carry out Federal program purposes, presently amounts to about $110 billion annually allocated among 435 separate Federal aid programs. Historically, the procedures followed for drawing down Federal money to redeem or to reimburse State checks or warrants have tended to vary between different programs, and between the respective departments or agencies, at the State and Federal levels, charged with administering the programs.

This lack of uniformity helped to exacerbate longstanding differences between Federal and State Governments over cash management practices in financing Federal assistance programs. While on the one hand, Federal officials alleged accurately that some administering departments at the State level were drawing down Federal funds too far in advance of need, costing the Federal Government foregone interest, the States on the other hand could point with justification to examples of Federal delays in reimbursing State funds advanced for Federal projects, such as highway construction.

The need for cooperation, rather than competition, between Federal and State Governments in achieving more efficient cash management was brought into focus in 1982, when the Department of Health and Human Services announced plans to implement a new cash management procedure called delay of drawdown/letter of credit. This calls for the establishment of historical check clearance patterns for Medicaid and AFDC payments, and reimbursement of States on the basis of these patterns, rather than permitting drawdown of funds when checks or warrants are issued as is the current practice.

This created difficulties for almost one half of the States, which have statutory or constitutional prohibitions against issuing checks or warrants without sufficient funds in the State treasury for that purpose. Because of the impasse on this issue between the States and HHS, several Senators urged that the delay of drawdown program be rescinded while the Federal and State Governments worked to reach an accord on how to proceed toward more equitable cash management principles.

To accomplish this, a Joint Federal/State Cash Management Reform Task Force was created in 1983at the request of the Chairman of the Governmental Affairs Subcommittee on Intergovernmental Relations. The Task Force consisted of six State fiscal officials and six Federal officials from OMB and the Departments of Treasury and Health and Human Services. In June 1983, the Task Force signed a Memorandum of Understanding which has governed all subsequent discussions, negotiations and agreements of the group. In addition, the Task Force agreed that no State would be required to adopt the delay of drawdown method unless it requested to do so. The seventeen intergovernmental cash management policies for financing Federal assistance programs, adopted by the Task Force, are attached as part of the June 1983 Memorandum of Understanding.

Following the policies established by that Memorandum, four States -- Virginia, Indiana, Wisconsin and California -- in conjunction with the Department of Treasury and other Federal agencies, conducted pilot programs to test several new cash management procedures. The pilot included the calculation of interest that would be exchanged between the Federal and State Governments for late reimbursement of funds advanced by the State for Federal program purposes and for early drawdown of Federal funds, respectively. Although interest was calculated, no interest was exchanged. These pilots were concluded successfully with regard to the cash management procedures; however, during the pilots, the States identified a number of issues that needed to be resolved in order to ensure equitable treatment for the States.

The Task Force sought to address the equity issues identified by the States and to incorporate solutions into proposed legislation as well as proposed amendments to Treasury regulations and OMB circulars. The November 1985 Memorandum of Understanding encompasses the basic agreements of the Task Force with which the Committee agrees. The Memorandum attached draft legislation, to amend sections 6501 and 6503 of title 31, which appears in substantially unchanged form as subsection (d) of section 7002 of this Act. The Committee understands that no interest will be exchanged under the provisions of the Treasury regulations or the OMB circulars until appropriate amendments to the Intergovernmental Cooperation Act have been signed into law.

III. LEGISLATIVE HISTORY

The three substantive provisions of section 7002 -- the disbursement objectives of subsection (c), the cash management and interest exchange provisions of subsection (d), and the National Lockbox Systems proposal in subsection

(e) -- were all previously contained in S. 2230, which was reported favorably by the Senate Committee on Governmental Affairs in 1986. Unfortunately, the full Senate was unable to act on these provisions prior to the adjournment of Congress.

On June 17, 1987 Senator William V. Roth, Jr. and Senator Jim Sasser introduced S. 1381, to bring the foregoing three legislative proposals once more to Congress' attention for consideration. The bill was assigned to the Committee on Governmental Affairs Subcommittee on Government Efficiency, Federalism, and the District of Columbia.

The Subcommittee held a hearing on S. 1381 on July 22, 1987. Testimony was received from the following witnesses: Gerald Murphy, Fiscal Assistant Secretary, U.S. Department of the Treasury, accompanied by Dr. Russell D. Morris, Assistant Commissioner for Federal Finance, Financial Management Service and Co-Chairman of the Federal/State Task Force; Jeffrey C. Steinhoff, Associate Director, Accounting and Financial Management Division, GAO, accompanied by Chris martin, Senior Accountant; and a panel of State fiscal officials including Frank L. Greathouse, Director, Division of State Audit, State of Tennessee; Edward J. Mazur, Comptroller, Commonwealth of Virginia and Co-Chairman of the Federal/State Task Force; F. Arnold Schuler, deputy controller, State of California; and Beverly Balakhovsky, chief accountant, State of Wisconsin.

All of the witnesses testifying expressed enthusiastic support for the cash management principles worked out by the Federal/State Task Force and reflected in S. 1381. However, due to some peripheral concerns expressed by State officials, and suggestions for language changes from officials at OMB and Treasury, the Subcommittee staff continued to work with Task Force members and other Government officials following the July 22 hearing and made a number of changes in the wording of S. 1381. These changes are identified and explained herein in the section-by-section analysis of section 7002 of this Act, which is a substitute for S. 1381 in the form of an amendment, offered by Senator Sasser for himself and Senator Roth.

IV. COMMITTEE VOTE

On October 16, 1987, the Subcommittee on Government Efficiency, Federalism, and the District of Columbia, by a unanimous vote of 5 to 0, polled out S. 1381, with the amendments to it which are reflected in the substitute amendment found in section 7002, Cash Management Improvements.

YEAS - 5   NAYS - 0

Sasser
Levin
Mitchell
Heinz
Cohen

V. SECTION-BY-SECTION ANALYSIS

Sec. 7002-Cash Management Improvements

This section is added as a substitute, by way of amendment, for S. 1381 introduced by Senators Roth and Sasser. Section 7002 incorporates some additional amendments to bill S. 1381, as explained below, which were arrived at as a result of discussions among representatives of Federal and State governments and subcommittee staff, following the hearing on S. 1381 on July 22, 1987.

Subsection (a)--Short Title

This subsection states that this section may be cited as the "Cash Management Improvement Act of 1987."

Subsection (b)--Purpose

This subsection states that the purpose of this title is "to increase equity in the exchange of funds between the Federal Government and the States," as well as to increase the efficiency of efforts to manage cash throughout the Government by providing additional incentives for cash management. The language quoted here was added to emphasize that equity and comparability of treatment in cash transfers, between the Federal Government and the States, is a cornerstone of this legislation. The incentives for improved cash management include (1) the establishment of disbursement objectives similar to collection objectives which were mandated in the Deficit Reduction Act of 1984 and are detailed in section 3720 of title 31, (2) the adoption of intergovernmental financing concepts developed by the Federal/State Cash Management Reform Task Force and agreed to in June 1983 and November 1985 memoranda of understanding, and (3) the expansion of the use of lockboxes as a means of speeding up the deposit of Government collections.

Subsection (c)--Disbursement objectives

This subsection adds subsection 3720B to subchapter II of chapter 37 of title 31 to allow Treasury to accomplish the same objectives for disbursements as are now permitted for collections under subsection 3720 of chapter 37.

Agency heads are to provide for the timely disbursement of Federal funds through cash, checks, or electronic funds transfer in accordance with regulations prescribed by the

Secretary of the Treasury. It is the Committee's understanding that the provisions of this subsection apply to disbursements for Federal assistance programs, and that the regulations to be prescribed by the Secretary will reflect that understanding.

The Secretary is authorized to collect from the agency an amount determined to be the cost to the general fund caused by an agency's noncompliance. In terms of disbursements, this means that the Secretary may in his discretion backcharge an agency for interest payments resulting from untimely reimbursement by the agency. The Secretary has comparable authority to collect costs of noncompliance with regulations, with regard to collections under existing subsection 3720. However, the Committee understands from discussions with Treasury officials that such authority, though often invoked to compel agency compliance, has rarely if ever been enforced. The Committee wishes to emphasize its understanding and intent that the same policy will be applied to the authority provided hereunder, i.e., that the Secretary will not routinely backcharge all interest payments incurred by an agency, but would do so only in instances of egregious or repeated noncompliance.

Two changes were made to the original text of S. 1381. First, at Treasury's suggestion any penalties which are charged against an agency will be deposited to Treasury to be credited as miscellaneous receipts (the "General Fund"), rather than to the Cash Management Improvements Fund. Second, language was added that any charge assessed against an agency under this subsection shall, "to the maximum extent practicable," be paid out of appropriations available for agency operations and shall not reduce program funding levels. This is to insure that the burden of the penalty is borne by the noncomplying agency, rather than by the States, which would suffer from any diminution in program funds. The language specifically quoted here is in recognition of the fact that funding is made available to certain agencies, such as the Highway Trust Fund, without differentiation between "operations budgets" and "program funds." Thus, the Secretary is granted some flexibility in assessing penalties, but is to adhere to the general principle that they not be paid out of program funds whenever this can be avoided.

Subsection (d)--Payment of interest

Subsection (d) contains the primary legislative recommendations of the Joint Federal/State Cash Management Reform Task Force to amend the Intergovernmental Cooperation Act (31 U.S.C. 6503(a)). The Committee's intent is: (1) to create a set of government-wide cash management policies and practices that can govern exchange of funds between the Federal and State Governments; (2) to establish intergovernmental cash management practices which assure that neither the Federal nor State Governments benefit or suffer financially as a result of the transfer of cash between the two governments; and (3) to ensure that the Federal and State Governments accord each other the same equitable treatment with regard to the timing and manner of transfers and management of funds.

In addition, the Committee understands that the Department of Health and Human Services and OMB are working with several States to test the feasibility of an annual grant award process as outlined in the Memorandum of Understanding of November 1985. The Committee strongly urges that consistent with the provisions of this Act, the Secretary of the Department of Health and Human Services shall continue existing state pilot test programs to determine the feasibility of establishing annual awards, for programs within the Secretary's jurisdiction in which awards have historically been made on a quarterly basis.

Subsection (d)(1) contains definitional amendments to section 6501 of title 31, stipulating that "Secretary" means the Secretary of the Treasury and that "State" means a State of the United States, the District of Columbia, a territory or possession of the United States, and an agency, instrumentality, or fiscal agent of a State but does not mean a local government of a State.

The amendment contained in subsection (d)(2), which replaces section 6503 of title 31, provides that:

(1) Consistent with program purposes and regulations of the Secretary, and by means mutually agreed upon by the Secretary and a State, the head of an executive agency is to minimize the time elapsing between the transfer of funds by Treasury and the issuance of payments by a State (subsection (d)(2)(a)); the same obligation to minimize this timeframe rests on a State (subsection (d)(2)(b)). It is the Committee's understanding that in accordance with the Memoranda of Understanding agreed to by the Task Force, each State will agree with the Secretary on a single procedure for drawing down Federal funds for all Federal programs administered by that State. This may be one of the following: "checks paid letter of credit," under which a commercial bank wires for Federal funds on a daily basis as checks are cashed (resulting in a net "zero balance" at day's end); the "delay of draw" method devised by HHS in 1982, under which a State first issues checks, and funds are then drawn down using historical clearance patterns to meet anticipated payment needs; "checks issued letter of credit with interest paid or credited," under which a State may continue to draw down funds in advance of issuing checks; or such other method as the Secretary and a State mutually agree upon. The Committee

understands that only the third option would result in interest becoming due from a State.

(2) The Secretary is to issue regulations that require a State to pay interest on Federal funds that are received in advance of need (from the time they are deposited to the State's account until the time they are paid out to redeem checks or warrants or to make payment by other means for program purposes) (subsection (d)(2)(c)(1)).

(3) Interest payments are to be calculated using the average bond equivalent rates of 13-week Treasury bonds auctioned during the period for which interest is calculated, as determined by the Secretary. The Committee understands that this period will typically be one year, since interest due to the Federal Government from a State (paragraph (2) above) and interest due to a State from the Federal Government (see paragraph (5) below) will be netted on an annual basis. The Committee further understands that the Task Force considered whether calculation should be made of "interest on interest" accrued during this annual period, but rejected this idea since it would overcomplicate the process for little appreciable benefit.

(4) Interest payments received by the Federal Government from a State are to be credited as miscellaneous receipts in the Treasury (subsection (d)(2)(c)(2)), with one exception. Under subsection (d)(2)(c)(3), in cases where the Secretary is required by law to invest funds in a specific account (such as the Highway Trust Fund, or the Unemployment Compensation Trust Fund), any interest payable by a State on monies received from such account shall be credited to that trust fund account. (This provision in the original text of S. 1381 has been "balanced," in the present section, by adding the contrary proposition: That if interest is paid to a State which advanced its own funds for Federal program purposes, while awaiting reimbursement from a trust fund (see paragraph (5) below), such interest shall be charged against such trust fund.)

(5) If a State disburses its own funds for program purposes in accordance with Federal law, regulation, or Federal-State agreement, the State is to be paid interest by the Federal Government using the same criteria applied to cases where the State receives Federal funds in advance of need (that is, from the time the State's funds are paid out to redeem checks or warrants, or make payment by other means, until the Federal funds are deposited to the State's account) (subsection (d)(2)(d)). This language is intended to include programs authorized under the Federal Aid Highway Program. Under present law, a State is not entitled to receive reimbursement for advancing its own funds for such programs, until the State has submitted a request for reimbursement or "billing" to the Federal Government. Nevertheless, it is

intended by the Committee that a State shall be entitled to calculate interest due to it from the Federal Government, after State funds have been used but prior to "billing," subject to the following conditions: (a) that the State relate such eligible amounts used to programs and projects that the Federal Government has approved, authorized, and placed under "Federal-State agreement," and (b) that the State is submitting reimbursement billings on a timely basis under such Federal-State agreement. The Committee anticipates that the Federal and State Governments, in negotiating each such agreement, will include provisions addressing the timeliness of submissions of highway construction reimbursement bills by the States to the Federal Government, and defining the period of time for which interest can be calculated prior to submission of these bills.

(6) Interest owed to a State by the Federal Government is to be paid in the first instance from funds in the Treasury not otherwise appropriated (commonly called the "General Fund") (subsection (d)(2)(d)). As discussed above, such amounts may in appropriate circumstances be recouped by Treasury in the form of a penalty against the agency involved; and in cases involving reimbursement to a State from a trust fund, interest is to be charged against such trust fund. To provide accountability, the President's budget (as submitted under section 1105 of title 31) is to specify for the most recently completed fiscal year interest paid to and by the Federal Government under the new section 6503 (subsection (d)(2)(e)).

(7) Where a State receives a refund of Federal funds (i.e., from a third source), those funds are to be returned to the applicable Federal agency program or applied to reduce any amounts owed the State by the Federal Government under the program. Interest earned by the State on these funds is to be returned to the Federal Government, and to accomplish this, these amounts are to be considered in setting the interest amounts due betweeen the State and Federal Governments. (Subsection (d)(2)(f); this section in the original bill, S. 1381, has been modified by deleting the qualifier, "grant" before the word "funds" to clarify that the new section 6503, unlike the old, deals with all cash transfers for Federal program purposes and not just grant funds as that term is defined in section 6501(4) of title 31. The same is true of subsection (d)(2)(h), discussed in paragraph (9) below.)

(8) The cash management principles detailed in the new section 6503 apply to programs (present or future) where the Federal Government makes payments in behalf of a State (subsection (d)(2)(g)). The principal example is the Supplemental Security Income program in which a number of States supplement the basic SSI grant. For this program, the

Federal Government makes the supplemental payment for a State by adding the State's amount to the check or payment the recipient receives from the Federal Government. A State's remittance to the Federal Government for the State share of the payment is to be timed to coincide with the clearance time of Federal checks or payments by any other means. If not, interest would be due the Federal Government under the provisions of this section. Similarly, if the Federal Government holds a State's remittance for its share of the payment in the Federal Treasury prior to making the payment to the recipient (meaning the State payment was made early), interest would be due the State under the provisions of this section.

(9) A State is not required to deposit money received from the Federal Government in a separate bank account, but is to account for these funds as Federal money and is to report periodically on the status and use of these funds (subsection (d)(2)(h); again, the terms "grant money" and "grant funds" in the original Senate bill have been modified to the more general terms "money" and "funds" for the reason heretofore stated). Records related to these funds are to be available to the agency head and the Comptroller General for auditing in accordance with the Single Audit Act (chapter 75 of title 31).

(10) The Secretary is to prescribe the methods of paying interest between the State and Federal Governments but must assure comparable treatment for both parties and may offset amounts owed (subsection (d)(2)(i)).

(11) The Inspector General, or an agency official performing similar functions where an Inspector General has not been established in law, is to periodically audit Federal agency implementation of this section (subsection (d)(2)(j)). States are expected to make similar reviews under the scope of work to be performed under the Single Audit Act (chapter 75 of title 31).

(12) Consistent with Federal program purposes and regulations, the Federal Government is to execute grant awards on a timely basis to assure the availability of Federal funds when needed by a State to make payments under a Federal program. (Subsection (d)(2)(k); authority to issue the regulations in question is vested in the Director of the Office of Management and Budget, rather than in the Treasury Secretary as in the original Senate bill, because of OMB's greater primary responsibility for carrying out grant awards.) As noted above, the Committee is anxious that HHS and OMB shall continue existing state pilot test programs to determine the feasibility of establishing grant awards on an annual basis, for programs in which awards have traditionally been made on a quarterly basis.

(13) Costs incurred by a State to determine the amounts due under this section are to be considered by the Treasury Secretary in establishing the amount of interest to be paid by a State (subsection (d)(2)(1)). It is anticipated that States will keep track of those payments for which interest should be paid by the Federal Government or a State and, if so, will be reimbursed for the additional cost to the State of determining the interest due. However, it is the Committee's intent that when the Secretary considers such costs, the effect of such costs upon the net amounts to be paid by the State or Federal Governments shall be reflected only in accounts maintained by the Treasury for the purpose of facilitating the interest exchange reflected in subsection (d)(2)(d) (i.e., interest not related to trust fund transactions), and shall not affect the amounts of interest that the Secretary is authorized to credit to or charge against trust funds, as provided under subsection (d)(2)(c)(3). Federal officials considered this clarification important because certain trust funds, such as that administered by the Federal Aid Highway Program, are prohibited to accept such charges for essentially "administrative" costs.

(14) Under subsection (d)(3), "the provisions of this section [7002(d)] and the amendments made by this section shall apply to all Federal programs and shall supersede the provisions of any Federal law or regulation in effect on the date of enactment of this law." It is the intent of the Committee that this cross-cutting language be construed to apply to all Federal assistance programs, including all trust funds for which the Secretary of the Treasury is the trustee; provided, however, that in prescribing administrative regulations the Secretary shall give due consideration to the particular requirements of construction programs authorized under the Federal Aid Highway Program.

Subsection (e)--Improving the Collection and Deposit of Government Receipts Through National Lockbox Systems

Subsection (e) is enacted for the purpose of improving the collection and deposit of Government receipts through lockbox systems. A lockbox system is the use of locked Post Office boxes to receive payments and to speed up the deposit of collections to the Government's account. Persons owing money to the Federal Government, instead of remitting the payment to the executive agency involved, transmit such payments to a lockbox. Payments are collected from the lockbox by a financial institution and credited to the Government's account without any action by the Federal agency involved.

The Secretary of the Treasury is to study and make recommendations for the establishment of lockbox systems. In making the study, the Secretary is to:

(1) consider, among other things, the feasibility and needs of each agency and the benefits and costs of establishing such systems;

(2) develop adequate internal controls and accounting procedures to protect the Government's interests and to assure that payments are promptly and fully credited to the Federal Government's account;

(3) develop criteria for adoption of lockbox systems by executive agencies;

(4) analyze the feasibility and costs of operating lockbox systems through Treasury, the Federal Reserve Board, or other appropriate executive agencies (rather than through a financial institution); and

(5) develop recommendations for the establishment of lockbox systems by executive agencies, with the cost of establishing and operating the systems to be paid by appropriated funds.

The report on the study is to be submitted to Congress within 180 days of the enactment of this subsection. Within 90 days following the report, the Secretary is to prescribe guidelines for establishing lockbox systems. The agencies then have 90 days to submit plans to the Secretary for implementing the guidelines and establishing lockbox systems, or else to specify reasons why a lockbox system is not feasible or cost effective.

DISABILITY PAYMENTS UNDER THE FEDERAL EMPLOYEES COMPENSATION ACT

The Committee has added language necessary to enforce disability payments required under the Federal Employee Disability Payment Act.

As required under current law each federal agency requests the necessary funds to compensate its injured workers, and such funds are transferred to the Department of Labor for actual payment to disabled workers. The objective of this system is so that each agency will be accountable for the safety of its workplace. The language added by the Committee makes the transfer of these funds from each agency to the Department of Labor automatic instead of making such payments discretionary.

Additional Views to the Subcommittee on Government Efficiency, Federalism, and the District of Columbia Report on S.1381, "The Cash Management Improvement Act of 1987"

ADDITIONAL VIEWS OF SENATOR ROTH

Ranking Minority Member of the Senate Governmental Affairs Committee

The ideas encompased in S.1381 have been worked on and discussed for a number of years. The work was done by the State/Federal Cash Management Reform Task Force which produced two memorandums of understanding, one in 1983 and 1985, as a means for ensuring equity in the exchange of funds between the Federal Government and the States. The documents show the progress of years of negotiation and cooperation between the Federal Government and the States. Many of these ideas were included in my omnibus federal management bill in 1986, S. 2230. S. 1381 focuses on the provisions of Title IV of that legislation.

The equity achieved in S.1381 is indeed a reflection of the work that went into it by all parties, the substitute amendment even more so. I thank Sen. Sasser for his work in bringing the States and the executive and legislative branches together again to work out the final draft of this legislation that has been accepted as a substitute.

The bill utilizes the "making whole" concept in that whoever has use of the money pays for it, compensating the other party for any loss of investment opportunity. Added to the bill is authority for the Treasury Department to penalize an agency that is chronically poor in its cash management. There is similar statute for the collection activity which was used as a model for disbursements in this legislation. Discussions to resolve technical problems and fine tune the bill as introduced, culminating in the bill we report today, reflected the air of cooperation that has carried this project since the Task Force's inception.

S. 1381 is an excellent example of how the legislative process should work. It has been debated by the parties involved and a compromise, satisfactory to all, has been drafted for the consideration of Congress. Partners in this effort have been Senators on both sides of the aisle, the Treasury, and the States. The bill will save the taxpayer money, will make government run more smoothly, and is agreed to by all sides. As I have said before, this is a piece of legislation whose time has come.

COMMITTEE ON LABOR AND HUMAN RESOURCES

Title VIII

EDWARD M. KENNEDY, CHAIRMAN

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United States Senate
COMMITTEE ON LABOR AND
HUMAN RESOURCES
WASHINGTON, DC 20510

October 16, 1987

The Honorable Lawton Chiles
Committee on the Budget
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

In response to the reconciliation instructions of the Committee on the Budget, the Committee on Labor & Human Resources recommends the attached legislative language which, if enacted into law, would meet the savings targets for the fiscal years 1988 through 1990. The Committee adopted this recommendation by a voice vote. Senator Quayle requested that his opposition to the measure be recorded; he has submitted the views attached to this letter to explain that opposition.

Sincerely,

Ted Kennedy

Edward M. Kennedy

Dan Quayle

MINORITY VIEWS OF SENATOR DAN QUAYLE ON PENSION RECONCILIATION

I regret that I have to register my opposition to this reconciliation bill. I strongly support the section of the reconciliation package which tightens funding standards with which plans must comply. The need for stronger funding standards is a matter of wide consensus among Members of Congress, business and labor. Underfunded pension plans present a serious threat to the Pension Benefit Guaranty Corporation (PBGC) and to the participants and beneficiaries of those plans. Under current law, a plan can meet all the funding and contribution requirements and still be dramatically underfunded. I hope that we have successfully addressed funding standards in a manner which will encourage optimal funding, particularly for those dangerously underfunded plans.

In addition, I favor meeting our reconciliation target by increasing Title IV insurance premiums for the Pension Benefit Guaranty Corporation, although I object to the flat rate increase. Uncertainties in the steel industry make it imperative that we infuse the PBGC with cash.

However, there are two parts of the package with which I have strong dissent. The first, to which I alluded above, is the flat rate premium. Last year Congress raised single-employer defined benefit pension insurance premiums from $2.60 per participant to $8.50 per participant. Now the Labor and Human Resources Committee has raised them to $20 per participant. Premiums are jacked up on a flat rate basis without regard to the amount of risk to which the plan exposes the PBGC. The effect is that responsibly funded plans pay for the unfunded benefit promises of bankrupt pension plans. As a matter of public policy, the Congress should consider a premium which varies in accordance with the degree of risk to which the plan exposes the PBGC. Such a premium structure would encourage better funding, as a plan's premium payments would decline as the funded status of the plan improved.

The second reason for my dissent is that in its treatment of overfunded pension plans, the committee meddles in an area unrelated to its reconciliation instructions - an area that presents neither a threat to the solvency of the system nor is related to the funding of the PBGC. These changes are inconsistent with and detrimental to a soundly conceived defined benefit pension plan system.

The reported bill requires an overfunded single-employer plan to make a gift equal to the amount of the overfunding (up to 25% of the plan's liabilities) to employees and retirees. Overfunded pension plans present little risk to the pension insurance system. To require a terminated, overfunded pension plan to make bonus payments to plan participants of the excess assets sets a dangerous precedent which is found nowhere in ERISA's extensive legislative history. This proposal undermines the principle that an employer is responsible for the benefit he has promised, and in it, Congress declares that employees are entitled to more than the full amount contained in their employment contract.

The provisions in this package dealing with overfunded pension plans blur the distinction between defined benefit and defined contribution pension plans in a manner which will hasten the decline of the defined benefit pension system. In a defined benefit pension plan, the employer promises a benefit and bears all the risk to pay the full amount of the promise when it becomes due. In a defined contribution plan, the individual employee bears all the risk of investment performance for the money in his account.

Under the provisions of this package, the employer bears all the risk for full payment of his benefit promise, as under current law. But he accrues no benefit in exceeding in investment performance the amount needed to satisfy his promises.

For these reasons, I regret that I must record my dissatisfaction with the Labor Committee's reconciliation package. However, as I mentioned earlier, I strongly support those provisions which increase the overall security of the pension insurance system.

CBO COST ESTIMATE

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

October 20, 1987

Honorable Edward M. Kennedy
Chairman
Committee on Labor and Human Resources
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The Congressional Budget Office has prepared the attached cost estimate for the reconciliation proposal of the Committee on Labor and Human Resources, the Retirement Security Promotion Act of 1987, as ordered reported by the Committee on Labor and Human Resources, October 9, 1987.

If you wish further details on this estimate, we will be pleased to provide them.

With best wishes

Sincerely,

Edward

Edward M. Gramlich
Acting Director

cc: Honorable Orrin G. Hatch
Ranking Minority Member

CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

October 20, 1987

1. BILL NUMBER: None.

2. BILL TITLE: Retirement Security Promotion Act of 1987.

3. BILL STATUS:

   As ordered reported by the Senate Committee on Labor and Human Resources on October 9, 1987.

4. BILL PURPOSE:

   To increase the Pension Benefit Guaranty Corporation (PBGC) single-employer premium, to change the minimum funding standards for private pensions, and for other purposes.

5. ESTIMATED COST TO THE FEDERAL GOVERNMENT:

(by fiscal year, in millions of dollars)

	1988	1989	1990	1991	1992
Pension Benefit Guaranty Corporation					
Budget Authority	0	0	0	0	0
Outlays	-380	-260	-220	-220	-220
Decrease in Revenues	35	100	200	300	400
Net Deficit Effect	-345	-160	-20	80	180

The spending effect of this proposal would be shown in Function 600.

Basis of Estimate

Premium Increase. The proposal would increase the premium of the single-employer pension insurance program of the PBGC from $8.50 per participant to $20.00. The premium increase would be effective for plan years beginning after December 31, 1987, and is estimated to increase premium income by $300 million in fiscal year 1988, increasing to approximately $390 by fiscal year 1992.

Premium income goes to the PBGC's on-budget revolving fund, and benefit payments for participants in terminated underfunded plans are made from this fund. These benefit payments are financed by premium income and by transfers from the PBGC's off-budget trust fund, which holds the assets of terminated plans taken over by the PBGC. Outlay savings that occur because of higher premiums would decline during the next few years because the income generated lowers the need for transfers from the PBGC's off-budget trust fund to the on-budget revolving fund. Because of this loss of income from the off-budget trust fund, the outlay savings do not equal the full increase in premium income.

Minimum Funding Standards and Other Provisions. Employers whose plans are underfunded would be required to increase plan contributions. Experience gains and losses would also have to be amortized over 3 instead of 15 years. These and other provisions would require increased plan contributions by employers which would lower taxable profits and wages and thereby reduce revenues.

6. ESTIMATED COST TO STATE AND LOCAL GOVERNMENT:

CBO estimates that this proposal would have no effect on the budgets of state and local governments.

7. ESTIMATE COMPARISON: None.

8. PREVIOUS CBO ESTIMATE: None.

9. ESTIMATE PREPARED BY: Michael Pogue (226-2820)
Larry Ozanne (226-2684)

10. ESTIMATE APPROVED BY:

C.G. Nuckols
for James L. Blum
Assistant Director
for Budget Analysis

COMMITTEE ON VETERANS' AFFAIRS

Title IX

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United States Senate
COMMITTEE ON VETERANS' AFFAIRS
WASHINGTON, DC 20510-6375

October 19, 1987

Honorable Lawton Chiles
Chairman
Honorable Pete V. Domenici
Ranking Minority Member
Committee on the Budget
United States Senate
Washington, D.C. 20510

Dear Lawton and Pete,

Pursuant to section 4(j) of the Concurrent Resolution on the Budget for Fiscal Year 1988 (H. Con. Res. 93), and action of the Committee at a July 31, 1987, meeting and by poll conducted by letters dated October 14, 1987, the Committee on Veterans' Affairs is submitting to the Budget Committee the enclosed legislative and report language recommending budget savings. The reconciliation instructions contained in section 4(j) of H. Con. Res. 93 require this Committee to report changes in laws within this Committee's jurisdiction sufficient to reduce both budget authority and outlays for veterans' programs by $50 million in fiscal year 1988 and $30 million in fiscal year 1989 and outlays by $10 million in fiscal year 1990.

In order to meet these requirements, our Committee unanimously voted to recommend in the enclosed legislation that the proportion of Veterans' Administration acquired foreclosed properties sold on a cash rather than vendee-loan basis be increased from a maximum of 40 percent and a minimum of 25 percent to 60 percent and 40 percent, respectively, and that the Administrator's discretionary authority to increase the proportion of vendee-loan sales of such properties when "necessary in order to maintain the effective functioning of the loan guaranty program" be decreased from 80 percent to 70 percent.

We believe that these recommendations provide the most reasonable means for the Committee to comply with our reconciliation instructions consistent with our commitment to reducing our national deficit while continuing to provide fair and equitable treatment to the veterans of our Nation.

Cordially

Alan
Alan Cranston
Chairman

Frank
Frank H. Murkowski
Ranking Minority Member

Enclosures

TITLE IX -- BUDGET RECONCILIATION RECOMMENDATIONS OF THE SENATE COMMITTEE ON VETERANS' AFFAIRS

PURSUANT TO H. CON. RES. 93

INTRODUCTION

Under section 4(j) of the Concurrent Resolution on the Budget for Fiscal Year 1988, the Senate Committee on Veterans' Affairs is required to submit to the Senate Committee on the Budget recommendations for changes in the laws within the jurisdiction of the Committee on Veterans' Affairs sufficient to reduce both budget authority and outlays by $50 million in fiscal year 1988 and $30 million in fiscal year 1989 and outlays by $10 million in fiscal year 1990.

On February 18, 1987, in preparation for the submission of this Committee's views and estimates on the fiscal year 1988 budget for programs within its jursidiction, the Committee held a hearing on issues concerning the fiscal year 1988 budget for veterans programs. The Committee heard testimony on several cost-savings measures at that time, including the Administration's proposal to increase the number of acquired foreclosed properties which the Veterans' Administration is required by statute to sell on a cash rather than vendee-loan basis. On June 17, 1987, the Committee held a hearing on issues, also including that proposal, concering the VA home loan guaranty program. At a July 31, 1989, meeting, the Committee voted unanimously to submit to the Budget Committee as its recommendations for savings to be included in a Senate reconciliation bill, the legislative provision to achieve the requisite cost savings by increasing such cash sales as discussed below. Through a poll conducted by letters dated October 14, 1987, the Committee voted unanimously to amend such legislative provision to include a prosivion to decrease, from 80 to 70 percent, the level to which the Administrator of Veterans' Affairs may, as a matter of discretion, increase the proportion of such vendee-loan sales. According to the Congressional Budget Office (CBO), that amendment has no impact on the cost savings which the provision would achieve.

DISCUSSION

In the Deficit Reduction Act of 1984 (Public Law 98-369), Congress enacted provisions, codified in section 1816(d) of title 38, United States Code, requiring the VA, during fiscal years 1984 through 1987, to sell no less than 60 percent and no more than 75 percent of its acquired foreclosed properties through vendee loans, but giving the Administrator the discretionary authority to increase the proportion of vendee loan sales to 80 percent "when necessary in order to maintain the effective functioning of the loan guaranty program". Title IX would amend section 1816(d) so as to require generally that, for fiscal years 1988 to 1990, a minimum of 40 percent and a maximum of the sales of those properties be sold on a vendee-loan basis and to provide the Administrator with discretionary authority to increase to 70 percent, rather than 80 percent, the permissible level of vendee-loan sales. The CBO estimates that these legislative changes would produce savings sufficient to satisfy the reconciliation requirements.

Buyers ("vendees") of properties the VA has acquired as a result of defaults on VA-guaranteed loans have two options available with respect to financing: (1) they can pay cash (which generally is in the form of a loan from a conventional lender), or (2) if they qualify under the VA's underwriting criteria, they can obtain vendee financing from the VA (whereby the VA acts as the lender).

The Committee believes that one of the significant advantages of using increased cash sales to generate its required reconciliation savings is that it achieves these savings without reducing benefits to or increasing fees imposed on veterans.

The legislation satisfies section 202 of the Balanced Budget and Emergency Deficit Control Act of 1987 (Public Law 100-119), subsection (a) of which generally prohibits treating a law that transfers a receipt from one fiscal year to an adjacent fiscal year as altering the deficit or producing a net deficit reduction. Subsection (b) of that section provides that the subsection (a) prohibition "shall not apply if the law making that transfer stipulates that such transfer . . . achieves savings made possible by changes in program requirements . . . ." The Veterans' Affairs Committee-recommended legislation states that, for the purposes of these provisions, it achieves savings made posible by changes in program requirements, namely by requiring a greater proportion of cash sales and a reduced proportion of Government loans.

CBO COST ESTIMATE

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

October 20, 1987

Honorable Alan Cranston
Chairman
Committee on Veterans' Affairs
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The Congressional Budget Office has prepared the attached revised cost estimate for the provisions reducing spending in programs within the jurisdiction of the Senate Committee on Veterans' Affairs, as ordered transmitted to the Senate Committee on the Budget by the Senate Committee on Veterans' Affairs, July 31, 1987.

The estimates included in the attached report represent the 1988-1992 effects on the federal budget and on the budget resolution baseline of the Committee's legislative proposals. CBO understands that the staff of the Committee on the Budget will be responsible for interpreting how the savings contained in these legislative proposals measure against the budget resolution reconciliation instructions.

If you wish further details on this estimate, we will be pleased to provide them.

With best wishes,

Sincerely,

Edward M. Gramlich
Acting Director

cc: Honorable Frank H. Murkowski
Ranking Minority Member

CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

October 20, 1987

1. BILL TITLE:

   Provisions reducing spending in programs within the jurisdiction of the Senate Committee on Veterans' Affairs.

2. BILL STATUS:

   As ordered reported by the Senate Committee on Veterans' Affairs, July 31, 1987.

3. BILL PURPOSE:

   To reduce expenditures authorized by the Senate Committee on Veterans' Affairs in response to budgetary requirements established for that committee by the First Concurrent Resolution on the Budget for fiscal year 1988.

4. ESTIMATED COST TO THE FEDERAL GOVERNMENT:

   The budget impact of this bill is shown in the summary table below, relative to the budget resolution baseline as adjusted for P.L. 100-132. The effects relative to CBO's August baseline and its October budget baseline for fiscal year 1988, both adjusted for P.L. 100-132, are identical.

(By fiscal years, in millions of dollars)

	1988	1989	1990	1991	1992
Budget Authority	-111	-96	-82	16	12
Estimated Outlays	-111	-96	-82	16	12

The savings from this bill would fall in budget function 700.

Basis of Estimate

Under current law, the Veterans Administration (VA) cannot finance more than 75 percent or less than 60 percent of the sales of property that has been acquired from foreclosures of VA-guaranteed mortgages. This provision would change the range to not more than 60 percent or less than 40 percent during fiscal years 1988-1990.

The primary effect of this provision is that it would result in the receipt by the VA of the cash value of certain acquired properties approximately one year earlier than otherwise projected. As soon as the VA obtains clear title on an acquired property, they can offer it for sale. If the property is sold for cash, the VA recovers its cash value immediately. If, however, the VA finances the sale with a vendee loan, the agency does not recover the cash value of the property until the loan is sold. The lag time in this process generally runs about a year.

This bill contains a provision that would waive the provisions of section 202(a) of the Balanced Budget and Emergency Deficit Reaffirmation Control Act of 1987 (P.L. 100-119).

5. ESTIMATED COST TO STATE AND LOCAL GOVERNMENTS:

The Congressional Budget Office has determined that the budgets of state and local governments would not be directly affected by enactment of this bill.

6. ESTIMATE COMPARISON: None.

7. PREVIOUS CBO ESTIMATE:

On July 31, 1987, CBO transmitted a formal estimate of the Senate Veteran's Affairs Committee's reconciliation provisions to the Committee Chairman. The budgetary impact of the measure was estimated as shown below:

	(By fiscal year, in millions of dollars)				
	1988	1989	1990	1991	1992
Budget Authority	-56	-32	0	0	0
Estimated Outlays	-56	-32	-13	45	34

The July cost estimate has been invalidated by the enactment of Public Law 100-136, which requires VA vendee loans that are sold on the secondary mortgage market to be sold with full recourse to the government in the event of default. CBO considers such sales to be the equivalent of borrowing from the public and, therefore, requires that the receipts from the sales be scored as a means of financing, rather than as offsetting collections of the revolving fund.

In both the July cost estimate and this estimate, the majority of the outlay reduction results from the forward shift of receipts from the disposal of VA-owned real property. This shift occurs because more property would be sold for cash under the proposal and fewer of the sales would be financed by the VA. This effect is not changed by the new law.

Nevertheless, Public Law 100-136 affects the cost estimate of the reconciliation provisions in several ways. The primary impact results from the removal of the proceeds of the sale of vendee loans from the fund's offsetting collections. In the methodology of the original cost estimate, offsetting collections would increase because more properties are sold for cash but part of the increase would be lost because fewer vendee loans would be available for sale. With enactment of P.L. 100-136, however, the Loan Guaranty Revolving Fund will not be credited with collections from loan sales. Thus, the reduction in the proceeds from these sales would no longer offset the savings from higher cash sales receipts.

The July estimate also recognized the fact that the VA should realize a higher return on a cash sale of a property than would be realized from an equivalent vendee loan sold without recourse. This would occur because the VA currently offers a 5 percent discount on most cash sales of property, while it is expected that discounts in the range of 10-12 percent would be required to sell vendee loans without recourse. The different rates of return accounted for a small portion of the savings estimated in July. Loans sold with recourse, however, would only be discounted for differences in interest rates and, thus, could show a higher rate of return than cash sales of property. Therefore, there would no longer be any savings from this factor.

8. ESTIMATE PREPARED BY: K.W. Shepherd (226-2820).

9. ESTIMATE APPROVED BY:

C G Nuckols
for James L. Blum
Assistant Director
for Budget Analysis